

AUDITING

A PRACTICAL MANUAL FOR AUDITORS

BY THE LATE

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takings whose amateur auditors exercised their functions, presumably, 'to the satisfaction of all concerned' (especially of the criminals) until the moment when the crash occurred; and it is worthy of note that the crash never does occur until the defalcator has taxed his milch-cow beyond its strength, and that, when it does occur, it is not the amateur auditor who has brought it about. In fact, until the defalcator is fool enough to kill his golden goose, the amateur auditor always does 'continue to discharge his functions to the satisfaction of all concerned'; but does that prove the said auditor to be discharging his functions either capably or conscientiously? Assuredly not.

Probably the great bulk of the suffering caused by amateur auditors has arisen in connection with voluntary associations of persons joining together for such non-commercial purposes as building societies, friendly societies, slate clubs and the like; and unfortunately it is these very cases where the natural difficulty of the accounting renders a skilled and thoroughly impartial audit specially desirable. The members are commonly persons in humble circumstances, not themselves equipped by training or ability to make effective criticism of accounts presented to them, and on that ground if on no other their protection seems to be called for. The legislature made a half-hearted and curiously ineffective attempt towards a remedy in the Building Societies Act, 1894, and in the Friendly Societies Act, 1896.

Under Section 3 of the former 'notwithstanding anything in the rules of any society under the Building Societies Acts, one at least of the auditors of the society shall be a person who publicly carries on the business of an accountant'. As there is as yet nothing to prevent any person from publicly carrying on the business of an accountant, it is difficult to see what protection is in reality afforded.

The Friendly Societies Act, 1896, was (if possible) even more ineffective. Section 26 (1) reads 'every registered society and branch shall once at least in every year submit its accounts for audit either to one of the public auditors appointed as in this Act mentioned, or to two or more persons appointed as the rules of the society or branch provide'; and Section 30 (1) runs 'for the purpose of audits and valuations to be made under this Act the Treasury may appoint public auditors and valuers and may determine the rates of remuneration to be paid by societies and branches for the services of those auditors and valuers'. It will be noted that, for the purposes of this Act, it seems to have been assumed that two amateur auditors, no matter how lacking in qualification, are as good as one public auditor.

The weakness of the Friendly Societies Act, 1896, has been to a great extent corrected by the Industrial Assurance and Friendly Societies Act, 1948. By Section 20 of this Act, the designation 'approved auditor' is substituted for 'public auditor'. By Section 14, the option under Section 26 (1) of the Act of 1896, by which the accounts might be submitted for audit to 'two or more persons appointed as the rules of the society or branch provide' is confined to societies with (a) less than 500 members, and (b) assets of less than £5,000. In addition, the Registrar of Friendly Societies is empowered to reduce, by

regulation, these limits. Societies with members or assets in excess of the prescribed limits must now appoint an approved auditor.

Approved auditors are dealt with below under the heading 'official auditors'.

Amateur auditors are presented with a happy hunting ground by the provisions of the Local Government Act, Section 237, which will be dealt with in due course. At the moment the opportunity is taken to point out that under the Statute referred to the accounts of numerous local authorities are still submitted to the so-called audit of persons who need have no technical qualification whatever and who in fact are given few or no powers by the legislation under which they are elected.

The field which remains open to amateur auditors has been severely curtailed by recent legislation, in particular by the Companies Act,

OFFICIAL AUDITORS are a class that need not be considered here at any great length—the author's sole object being to produce a work of practical utility to the profession. The accounts of the British Government are audited by an official called the Controller and Auditor General, who is appointed by letters patent under the Great Seal. He is independent of any change of Government, holds office during good behaviour and is removable only on an address from both Houses of Parliament. Generally speaking his duties are to see that no money leaves the Consolidated Fund without statutory authority and to see that after it has so left the Fund it is properly applied. He is also to prepare accounts of income and expenditure for the Public Accounts Committee of the House of Commons.

The accounts of certain of the Colonies are audited by officers of the Colonial Audit Department under the Colonial Office.

Official auditors called district auditors act under the directions of the Ministry of Health in auditing the accounts of all local authorities, with the exception of municipal corporations, but the general lines followed in these audits appear to be entirely different from what would ordinarily be understood in connection with the term 'audit'. The object of an audit, properly so-called, is primarily to detect technical errors and errors of principle in the preparation of accounts, and to discover fraud, either in connection with the accounts themselves or in the handling of the money belonging to the undertaking. It is only indirectly that it becomes the auditor's duty to consider in detail the legality of the acts of those responsible for the conduct of the business and he usually disclaims any desire to influence the policy of the undertaking coming under audit. District auditors are, however, generally barristers, and the most important part of their duty appears to be to scrutinise the various *payments* with a view to seeing that they are not *ultra vires*. This is, of course, a very important matter in connection with local authorities, but it is to be regretted that the attention of district auditors should be—as in point of fact it is—almost entirely restricted to a scrutiny of the accounts from this point of view, with the result that, although the accounts are supposed to be checked with a view to detecting error and fraud, it has

frequently happened that dishonesty has remained undiscovered for a very considerable period, and that the accounts themselves are grossly inaccurate in essential particulars. It is suggested that, for the accounts of local authorities to be audited really effectively, the investigation of the district auditors, with their legal training, should be confined to a scrutiny of the various transactions from this point of view, the actual checking of the accounts themselves being performed by professional auditors, who, by their training are far better qualified than any lawyer to detect errors in book-keeping or dishonesty on the part of those having the handling of money. This, it is thought, is the true solution of the difficulty.

Before leaving this branch of the subject further reference should be made to those quasi-official auditors called 'approved auditors' who have already been noticed above. These appear to have been the creation of the Friendly Societies Act, 1896, Section 26 (1), quoted above. Under Section 2 (1) of the Industrial and Provident Societies (Amendment) Act, 1913, every society registered under that Act must 'once in every year submit its accounts for audit to one or more of the public auditors [now approved auditors] appointed under the provisions of the principal Act'. Furthermore, under Section 15 of the Industrial Assurance Act, 1923, the accounts of collecting societies are to be subjected to audit by an approved auditor.

Approved auditors are appointed by the Treasury acting through the Registrar of Friendly Societies. Formerly, the authorities used their own discretion in considering the qualifications of applicants desiring to be placed on the list of approved auditors, but in 1920 it was announced that new appointments would in future be confined to Chartered and Incorporated Accountants.

By Section 20 of the Industrial Assurance and Friendly Societies Act, 1948, no person is qualified for appointment as an approved auditor unless he is a member of one of the following bodies:

- The Institute of Chartered Accountants in England and Wales.
- The Society of Incorporated Accountants and Auditors.
- The Society of Accountants in Edinburgh.*
- The Institute of Accountants and Actuaries in Glasgow.*
- The Society of Accountants in Aberdeen.*
- The Association of Certified and Corporate Accountants.
- The Institute of Chartered Accountants in Ireland.

Membership of one of these bodies is not required in the case of a person who was an approved auditor when the Act was passed (30th June, 1948), and the Treasury is empowered to appoint as an approved auditor a person who has no qualification either by virtue of membership of one of the relevant bodies or by virtue of having been appointed before 30th June, 1948. In particular, if a society has exercised the option under Section 26 (1) to appoint two or more non-approved auditors in accordance with its rules the Treasury may appoint any such auditor as an approved auditor for the purposes only of the audit of the accounts of that society. The following is the official

* Now amalgamated as the Institute of Chartered Accountants of Scotland.

statement of the conditions under which approved auditors hold their appointments:

Conditions under which Approved Auditors hold their appointments

1. Approved auditors hold their appointments from year to year as from the 1st January. Any change of address must be communicated immediately to the Registrar of Friendly Societies.

2. An approved auditor may describe himself as an 'approved auditor under the Friendly Societies Acts and the Industrial and Provident Societies Acts', but must not by reason of his appointment use any other description.

3. Approved auditors should make themselves acquainted with the provisions of all statutes which concern the societies whose accounts they audit, and with the rules of those societies.

4. An approved auditor may not audit the accounts, balance sheet or annual return of any society or branch in which he, or a partner of his, holds any office of employment other than that of auditor. Subject to this he must not refuse to audit the accounts of any society or branch which is registered under either the Friendly Societies Act, 1896, or the Industrial and Provident Societies Act, 1893, unless he obtains the authority of the Registrar.

5. Every approved auditor must send a return of his audits, in the prescribed form, to the Registrar of Friendly Societies not later than 31st January. For the purposes of this return, he should keep a record of the registered names and numbers of societies audited, classified as in paragraph 8 below, their receipts and payments, and of his audit fees and additional charges (if any).

6. The appointment of an approved auditor who solicits audits by advertisement, circular, or otherwise, or by offering commission or other inducement to any person, or who acts as auditor at the request of a person who has been appointed as auditor but is not qualified to act, will be discontinued. An approved auditor who procures, assists or in any way makes himself a party to the solicitation of audits by others on his behalf, will also render himself liable to have his appointment discontinued.

7. On a change of auditor, the new auditor must communicate with the outgoing one before accepting the audit, and should ascertain the circumstances in which a change of auditor is proposed.

8. The maximum fees* allowed to be charged for auditing are set out below. These do not include any additional fees charged, by arrangement with the society, for work which is outside the scope of audit, nor travelling expenses.

(a) Societies or branches of societies, registered under the Friendly Societies Act, 1896, excluding working men's clubs and collecting societies:

	£	s	d
Not exceeding £3,000 of gross receipts	3	3	0
For every £1,000 in excess, up to £10,000	1	1	0
Above £10,000, fee to be fixed by special arrangement with the society.			

(b) Working men's clubs registered under the Friendly Societies Act, 1896, and clubs registered under the Industrial and Provident Societies Act, 1893:

	£	s	d
Where receipts and payments added together do not exceed £2,000	3	3	0
For every £2,000 in excess, up to £20,000	1	1	0
Above £20,000, fee to be fixed by special arrangement with the club.			

(c) Collecting societies:

	£	s	d
Where receipts and payments added together do not exceed £1,000	5	5	0
For every £1,000 in excess, up to £50,000	2	2	0
Above £50,000, fee to be fixed by special arrangement with the society.			

* As this volume goes to press, a revised scale of fees has been announced. The new scale, which applies to all societies other than collecting societies, is based on the aggregate of receipts and payments. Where such aggregate does not exceed £500 the maximum fee is £2 2s. 0d. and rises by stages to £21 in respect of an aggregate exceeding £18,000 but not exceeding £20,000.

- (d) Industrial and provident societies except agricultural and fishing societies and clubs:

	£	s	d
Not exceeding £3,000 of gross receipts	3	3	0
For every £1,000 in excess, up to £10,000	1	1	0
Above £10,000, fee to be fixed by special arrangement with the society.			

- (e) Agricultural and fishing societies registered under the Industrial and Provident Societies Acts:

	£	s	d
Not exceeding £2,000 of gross receipts	2	2	0
For every £1,000 in excess, up to £10,000	1	1	0
Above £10,000, fee to be fixed by special arrangement with the society.			

It will be noticed from the conditions quoted above that a person whose name is on the list is under an obligation to accept audits which may be presented to him subject to the single possible excuse that 'owing to the number of audits already undertaken he is unable to complete the audit by the statutory date'. It will be noted too that the maximum fee allowed to be charged is definitely laid down. Perusal of the figures will perhaps explain to the reader why the rush of applicants for appointment is not great. The existence of such an institution as 'approved auditor' in these days when the profession is organised upon a disciplinary basis and when professional accountants are practising all over the country is difficult to understand. As the list is now open only to members of the leading professional bodies (see above), it would seem more logical to abolish approved auditors altogether and to legislate to the effect that the accounts of societies now coming under their audit should be audited instead by duly qualified accountants in the ordinary way. Finally, it may be of interest to quote the Report of the Departmental Committee on Registration of Accountants (1930): 'The total funds of these latter societies' (i.e. those registered under the Friendly Societies Acts other than collecting societies) 'is about £100,000,000, and less than 6 per cent. of them employ public auditors. The other persons appointed as auditors are generally members of the societies: they sometimes have practically no knowledge at all of accounting. From time to time heavy losses occur as a result of incompetent audits.' Comment seems superfluous.

Section 13 (1) of the Public Trustee Act, 1906, gives authority for the accounts of any trust to 'be investigated and audited by such solicitor or public accountant as may be agreed on'; no definition is vouchsafed of what is meant by the phrase 'public accountant'.

One of the few official recognitions of the benefits of a professional audit was provided in 1898, when the Education Department issued an order requiring that the accounts of the receipts and expenditure of every school receiving a grant in aid from the Government should be annually audited by a chartered or incorporated accountant, or in special cases (i.e. presumably in rural districts where no professional accountant was available) by some other person—not being a manager or treasurer of the school—whose competence was proved to the satisfaction of the Department. The Education Acts of 1902 and 1903, however, placed all such schools under the control of local authorities,

abolished the professional audit, and—even in the case of those local authorities which under the Local Government Act, ----, are not required to submit their accounts to a Government audit, required that the accounts of the education authority are to be audited by district auditors attached to the Ministry of Health. By the Education Act, 1944, the only local education authorities are county and county borough councils, and education accounts are subject to audit by district auditors. In this respect, therefore, there has been a clear retrogression from professional to official audits. Under the National Health Service Act, 1946, the county and county borough councils are the local health authorities; by Section 55 (1) of that Act, the local health service accounts are subject to audit by district auditors.

Where municipal corporations coming under the provisions of the Local Government Act, 1933, desire to 'contract out' of the audit provisions of that Act, it is necessary for them to pass a resolution by a two-thirds majority in order to obtain power to appoint professional auditors. Under the old procedure when a special Act was necessary, it was customary to confine the power of appointments to members of the Institute of Chartered Accountants in England and Wales or of the Society of Incorporated Accountants and Auditors. In 1930, however, the petition of the London Association of Accountants* praying to be included in such a clause was granted. Now, under Section 239 (3) of the Local Government Act, 1933 (see Appendix A), the professional auditors appointed must be Chartered Accountants (English or Scottish), Incorporated Accountants or members of the London Association of Certified Accountants Ltd., or of the Corporation of Accountants Ltd.*

PROFESSIONAL AUDITORS are a class with whom the reader may fairly be considered to be well acquainted. Both on account of their special training, and on account of the fact that their energies are not distracted by other, and dissimilar, occupations, they are *par excellence* the ideal auditors. Moreover, the peculiar facilities they possess, in the shape of staffs of specially trained assistants, place them in the position to perform thoroughly audits of a magnitude that could not conscientiously be undertaken by any one man, no matter how skilled.

In Great Britain auditors are now thoroughly organised into professional societies. It must be stated, however, that these societies have been formed upon a purely voluntary basis and there is as yet nothing whatever to prevent a person professionally practising as an auditor, notwithstanding that he does not belong to any of the recognised societies. Various attempts have been made from time to time to secure what is called 'registration' by legislative enactment which, if passed, would set up a statutory register and which would prevent any person not on the register from practising for reward. No such measure has as yet been passed into law.

An idea of the relative importance of the various bodies of profes-

sional accountants practising in Great Britain may be gathered from the following list of societies (excluding bodies of persons not in public practice as auditors) which gave evidence before a departmental committee which reported in 1930 in connection with proposals for 'registration':

<i>Date of Incorporation</i>	<i>Name</i>	<i>Membership (in 1930)</i>
1854 (By Charter) (formed 1853)	‡Society of Accountants in Edinburgh.	952
1855 (By Charter) (formed 1853)	‡Institute of Accountants and Actuaries in Glasgow.	1,825
1867 (By Charter) (formed 1866)	‡Society of Accountants in Aberdeen.	163
1880 (By Charter)	Institute of Chartered Accountants in England and Wales.	9,047
1885	Society of Incorporated Accountants and Auditors.	5,225
1891	†Corporation of Accountants Ltd.	1,927
1903	*Institution of Certified Public Account- ants Ltd.	175
1905	†London Association of Accountants Ltd.	2,900
1905	*Central Association of Accountants Ltd.	739
1923	British Association of Accountants & Auditors Ltd.	333
1927 (formed 1925)	Society of Statisticians and Account- ants Ltd.	300 (approx.)
1927	Professional Accountants' Alliance Ltd.	158
1928 (formed 1927)	Faculty of Auditors Ltd.	200 (approx.)

* These bodies have now (1933) amalgamated as 'The Institution of Certified Public Accountants'

† These bodies are now amalgamated as the 'Association of Certified and Corporate Accountants Ltd.'

‡ These bodies are now amalgamated as the 'Institute of Chartered Accountants of Scotland'.

The continued growth of the profession is shown by the following figures:

	<i>Membership on 31st December, 1947, or 1st Jan- uary, 1948</i>
Institute of Chartered Accountants in England and Wales.	13,597
Society of Incorporated Accountants and Auditors.	7,894
Association of Certified and Corporate Accountants.	7,288

It will be seen from the statistics given above that professional auditing in England and Wales is practically wholly in the hands of the Institute of Chartered Accountants, the Society of Incorporated Accountants and Auditors and the Association of Certified and Corporate Accountants. It is not desired to draw any invidious distinction between these bodies but the evidence before the Departmental Committee elicited as a fact that of the 100,000 or so public and private companies then registered under the Companies Act, there are roughly 5,500 whose shares are listed in the Official Intelligence of the London Stock Exchange. Of this number 90 per cent. were audited by firms all the partners of which are chartered accountants, 3 per cent. by firms all the partners of which are incorporated accountants, and

3 per cent. by firms all the partners of which are either chartered or incorporated accountants.

There is a strong tendency in recent legislation to prescribe membership of a professional body as a condition for appointment as an auditor. The various measures in which such a condition is prescribed, although they are unco-ordinated, are welcome steps in the right direction.

One of the earliest measures of this kind is found in Section 137 (3) (a) of the Income Tax Act, 1918, as amended by Section 25 of the Finance Act, 1923, which reads as follows: 'Upon any appeal, the general commissioners shall permit any barrister or solicitor to plead before them on behalf of the appellant or officers, either *viva voce* or in writing, and shall hear any accountant.' Section 137 (3) (c) reads: 'In this subsection, "accountant" means a person who has been admitted a member of an incorporated society of accountants.'

The Companies Act, 1948, contains a provision of very far-reaching importance. By Section 161 (1), no person shall be qualified for appointment as auditor of a company unless he is either a member of a body of accountants established in the United Kingdom and recognised for this purpose by the Board of Trade, or is individually authorised by the Board of Trade. This requirement does not apply to 'exempt private companies', as defined in Section 129 of the Act. (See Chapter VIII.) The professional bodies recognised by the Board of Trade for this purpose are the following:

The Institute of Chartered Accountants in England and Wales.

The Society of Incorporated Accountants and Auditors.

The Society of Accountants in Edinburgh.*

The Institute of Accountants and Actuaries in Glasgow.*

The Society of Accountants in Aberdeen.*

The Association of Certified and Corporate Accountants.

The Institute of Chartered Accountants in Ireland.

By Section 1 of the Solicitors Act, 1941, every solicitor (with certain exceptions) must deliver annually to the Registrar of Solicitors an accountants' certificate. In this certificate, the accountant must state whether or not he is satisfied that the solicitor has complied with the Solicitors' Accounts Rules. The Solicitors' Accounts Rules, 1945, made under the provisions of the Solicitors Act, 1933, are designed to enforce upon solicitors who hold money on behalf of clients the segregation of clients' money in a special bank account. By Rule 3 of the Accountants' Certificate Rules, 1946 (made under Section 1 of the Solicitors Act, 1941), an accountant is qualified to give the required certificate only if he is a member of one of six specified professional bodies. The professional bodies recognised for this purpose are those mentioned above, with the exception of the Institute of Chartered Accountants in Ireland.

It has also been observed above that, under the Industrial Assurance and Friendly Societies Act, 1948, no person is qualified for appointment as an approved auditor unless he is a member of one of seven specified professional bodies, and it will be noted that the specified bodies are

* Now amalgamated as the Institute of Chartered Accountants of Scotland.

the same as those recognised by the Board of Trade for the purposes of the Companies Act, 1948.

Similar provisions are included in many of the enactments by which a number of industries have been transferred to public ownership. The important question of the impact of nationalisation upon the profession is considered in the last part of this chapter, to which the reader is referred for details.

The general trend of legislation is thus to restrict to an ever narrowing field the activities of unqualified auditors.

It is quite clear that in no circumstances can any professional audit be regarded as so complete a safeguard as to constitute, in effect, an 'insurance' against fraud, and it has been expressly held by the Court of Appeal that an auditor 'is *not* an insurer' (*vide* the judgment of Lord Justice Lindley in the *London and General Bank* case). There is, however, a great difference between holding an auditor liable as an insurer, and expecting him to provide such reasonable safeguards as will, under all normal circumstances, preserve the undertaking against loss owing to dishonesty. A fire brigade is of undeniable use, but it does not insure against fire. Dealing with the matter first of all from the purely commercial—and therefore from the lowest possible—standpoint, the minimum premium charged by an insurance company for a guarantee of honesty is 10s. per cent., and a higher premium is almost invariably charged in the case of employees. A comparison of this figure with most audit fees will show that, if any credit at all is to be given for the actual work of examining the accounts (which work is, of course, never performed by a guarantee insurance company), little, if anything, remains to cover an 'insurance' of the honesty of the staff; while a slightly broader—and therefore more common-sense—view of the situation must, of course, show that the risks which insurance companies, with their large paid-up and still larger uncalled capitals, can afford to run in the ordinary course of their business are far different from the risks that any individual professional man could prudently accept. Thus, on the grounds of law, equity, and expediency alike, it is clear that an auditor does not guarantee his client against all loss by dishonesty. This, however, is, it need perhaps hardly be pointed out, a very different thing indeed from an entire disclaimer of all pecuniary responsibility. The mere fact of an auditor attaching his signature to the accounts of an undertaking, *qua* auditor, is a distinct 'representation' to all whom it may concern that the accounts in question have been audited by him; and all, therefore, who are entitled to rely upon this representation are clearly entitled to the assurance (using the word in its popular sense) that the work alleged to have been performed has been conducted with a reasonable amount of skill and care. The exact effect of this 'assurance' in each separate case must, of course, be determined upon the merits of that case; but the safeguard afforded by this personal responsibility of the auditor is, in itself, by no means a negligible quantity. Further, it may be pointed out that, in the case of professional auditors, whose living depends upon their reputation for skill and care, a far greater measure of security is provided than the mere legal limit of the responsi-

bility of the auditor. For obvious reasons it would be inexpedient to strain this legal responsibility too far, or the effect would inevitably be to drive men of substance out of the profession; the chief safeguard of a professional audit, and its great superiority over an amateur audit, lies thus not in any increased measure of legal responsibility (for the law recognises no distinction between professionals and amateurs), but in the safeguard afforded by the fact that the professional depends for his livelihood on his business reputation as a careful and skilful auditor, whereas the amateur obviously does not. At the same time, the efforts that have been made in some quarters to reduce the legal responsibilities of auditors to vanishing point must be strongly deprecated.

THE AUDITOR'S QUALIFICATIONS. In England the only professional body which insists upon service under articles for a term of years as an essential condition of admission to membership is the Institute of Chartered Accountants. The normal period is five years but this is reduced to three years in the case of university graduates. The Society of Incorporated Accountants and Auditors also provides for articles as the normal means of entry (in addition, of course, to examination), but in this case long practical experience is sometimes allowed as a substitute. Both these bodies provide for preliminary, intermediate and final examinations before admission to membership, and it is common knowledge that the standard demanded is exceedingly high. The curriculum of the Institute of Chartered Accountants may be taken as an example. Exemption from the preliminary examination may be granted to a person who has passed one of the specified exempting examinations, the standard of which is that of university matriculation. A number of universities provide degree courses in which accountancy is taken as a main subject, and graduation under this scheme carries with it exemption from the professional intermediate examination. The preliminary examination is roughly of the standard of university matriculation. The intermediate examination includes papers in book-keeping and accounts (including limited companies, partnership and executorship)—three papers—auditing, general commercial knowledge (including the elements of English law), taxation and cost accounting. The final examination covers advanced accounting—two papers—auditing, taxation, general financial knowledge and cost accounting, and English law (two papers), including company law, the law of bankruptcy, arbitration, and trusts, and mercantile law. It may be mentioned that the standard of examination is so high that it is usually found that a substantial proportion of the candidates fail to satisfy the examiners.

Full details of the technical qualifications demanded by the various professional bodies may be obtained by direct application and the main purpose in referring to the matter in this work is to draw attention to certain qualities not merely of professional ability but of personal attainment and character which ought to distinguish the auditor.

First, then, it is essential that a rigorous and exhaustive knowledge of accounting in all its branches should be regarded as the *sine qua non*

of the practice of auditing. The auditor is called upon constantly to criticise accounts and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert.

Second in importance is a thorough grasp of the general principles of law which govern the matters with which he is likely to be brought into intimate contact. The law of companies and of partnerships forms a prominent example but probably the law of contract and that general body of rules known as mercantile law are no less important. Needless to say, too, where undertakings are governed by special statute it is essential that an intelligent study of those documents should be undertaken. In addition, a sound knowledge of the law and practice of taxation is essential.

Thirdly, it is incontestable that the auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but with an understanding of the special features peculiar to the various particular businesses with which he comes in contact.

Lastly, but not least, may be placed those desirable qualifications of the auditor which are not acquired by careful study, but rather, by *living*. Tact, caution, firmness, fairness, good temper, courage, integrity, discretion, industry, judgment, patience, clear-headedness, and reliability. In short, all those qualities that go to make a good business man contribute to the making of a good auditor; while that judicious and liberal education which is involved in the single word 'culture' is most essential for all who would excel. Auditing is a profession calling for a width and variety of knowledge to which no man has yet set limit, and the most useful part of that knowledge is probably that which cannot be learned from books because its acquisition depends on the alertness of the student in applying to ever-varying circumstances the fruits of his own observation and reflection.

AUDIT CLERKS. It will not be amiss, before leaving this subject to consider, very briefly, the desirable qualifications of an audit clerk. Conscientiousness may be placed in the foremost rank. A large amount of uninteresting detail must inevitably form a part of the clerk's daily routine; and the fact that the greater portion of such work may generally be scamped without any great danger of detection, affords considerable temptation, both to the naturally slow worker, and to the gentleman of elastic conscience who wishes to make a little spare time for himself. Reliability is the first requisite in a clerk, and the clerk who wishes to get on must endeavour to earn a reputation for being 'safe'. Next, the clerk would be wise—especially the young clerk—not to get too friendly with his client's staff. Let him be cautious of accepting favours, and let him refuse absolutely the acceptance of presents, which might be regarded by the donor or by third parties as bribes. Imagination (under proper control) is another very desirable quality in a clerk; for, without it, he is apt to become a mere machine, and consequently absolutely useless to the auditor.

THE AUDITOR'S APPOINTMENT. The position of the auditor varies to a certain extent with the nature of his appointment, and it will therefore be well to consider the circumstances separately.

APPOINTMENT TO ACT AS ACCOUNTANT, NOT AUDITOR. We must begin by making a very careful distinction between cases where an accountant is engaged to perform duties of an accounting nature which are short of those of an auditor, and cases where a true audit is to be performed. The great importance assumed by income-tax in modern times has brought this distinction into prominence because very often accountants are appointed to make income-tax computations and to prepare income-tax returns; cases frequently occur where these duties insensibly assume the appearance of auditing, and many very unfortunate disputes have arisen; quite clearly, it is one thing for an accountant to take figures given to him and, as it were, to translate them into income-tax terms; but it is quite another to take the responsibility for the intrinsic accuracy of the figures themselves. The antithesis is that which exists between accountancy and auditing, and it is of the greatest importance, both for accountant and client, that each party should be quite clear as to the nature of the engagement.

We may illustrate the nature of the distinction now in mind by reference to the Irish case *Leech v. Stokes and others* ([1937] 81 *Acct. L.R.* 87). In that case accountants had been instructed to prepare annual profit and loss accounts of a firm of solicitors for submission to the taxation authorities. The evidence showed that, to say the least of it, proper books were not kept and although the practice included the collection of rents on a large scale, no proper cash book and no clients' ledger was maintained. Hence, quite apart from instructions, it was not possible to prepare a balance sheet. The cashier produced a document called a costs furnished book, containing particulars of the bills rendered against clients, and weekly summaries of the firm's expenses, and from these figures the profit and loss accounts were prepared. When, later, it was found that rents collected had been misappropriated, a claim was made against the accountants in respect of negligence and breach of duty.

At the trial the judge laid stress on a letter written by the accountants and accompanying the first year's account, which letter 'states clearly that the account is merely a mechanical compilation of the figures from the costs furnished book and it refers to the information given verbally to the auditors and not contained in the book'. Further, since the misappropriations were all of clients' moneys, the profit and loss account was not affected (until the necessity arose to make good to the clients concerned) and 'all the accounts prepared and sent in to the Inspector of Taxes were correct in fact'. The accountants had advised that proper books should be kept but their recommendations were not acted on. It was ultimately held (and confirmed by the Court of Appeal) that 'the instructions given to the defendant firm were to prepare a report of profits for the Inspector of Taxes' and that 'in this case there was no proper material available for the preparation of a balance sheet' as might otherwise have been desirable. Hence 'there was no actionable negligence or breach of duty on the part of the defendants in any of the matters relied upon'.

Accountants have not always found it so easy as in this case to

defend themselves against claims and, indeed, many income-tax engagements have ended by loading the unfortunate accountants with the responsibilities of auditors. The moral seems to be that the nature of the engagement should be recorded in writing between the parties and that (especially in default of such a memorandum) the accountant should be careful to complete his work by making a written report in terms which can leave no doubt as to the restricted nature of the duties undertaken.

Reference may also be made to rather similar facts in *Apfel v. Annan, Dexter & Co.*, reported in Appendix B.

THE AUDITOR TO AN INDIVIDUAL will, in almost every instance, receive his appointment from such individual in person; the appointment being—in the absence of stipulation to the contrary—for the period covered by the revenue account, but renewable upon the same terms for each successive period, unless a contrary arrangement be made. The fee for the first audit is sometimes settled beforehand, but more usually left open until the time occupied has been ascertained, the fee for subsequent audits being usually arranged after the completion of the first audit. Naturally, the fee charged will be a matter of arrangement; but, in the event of no definite sum having been settled, the auditor would—in a case of disagreement—be entitled to such sum as a jury would award, which would probably be the usual professional charges. An auditor instructed by an individual incurs all the liabilities falling on a professional man undertaking for reward to exercise his skill. It is therefore desirable that if the client desires that only a partial audit should be performed the understanding between the parties should be recorded in writing so that subsequent disputes may be avoided. Further, when accounts subjected to an audit limited in scope, are delivered to the client, it is desirable that they should bear a clear reference to a report, which report should specify the restriction in question, lest third parties into whose hands the accounts may come, should suffer loss through misapprehension.

An auditor may resign his office at any time, but it is doubtful whether he could then claim to be paid for the time occupied upon an uncompleted audit. On the other hand, the client may at any time discharge his auditor, but he would probably be held liable for the whole fee of the current period, if the audit had actually been commenced. In any case, no point of law peculiar to auditing is involved.

THE AUDITOR TO A FIRM is usually appointed by the mutual agreement of the partners; but, occasionally, in accordance with the articles of partnership themselves, or by one particular partner. If appointed auditor *to the firm*, he must, however, in every case, consider *each* partner as his client, and protect the interests of each accordingly. The same conditions as to terms of agreement, responsibility, fees, and resignation apply to the auditorship of firms as were mentioned in the preceding paragraph; but any one partner would have power to bind the firm as to the amount of the fees—except,

perhaps, where the appointment lay in the hands of one partner, when the consent of such partner would apparently be required. Probably no one partner could discharge an auditor without the consent of all his co-partners.

This seems the proper place to point out that where an auditor so acts for all the partners it is incumbent on him to report on matters internal to the partnership whereas, otherwise, he might confine his attention to transactions between the partnership and the outside world. It not infrequently happens that the letter, if not the spirit, of partnership agreements is broken from time to time; and, so far as these infractions of the agreement relate to accounts, it is clearly the duty of the firm's auditor to draw attention to the position of affairs in his report. The most usual irregularity of this description is for one or more of the partners to exceed the amount which they are entitled to draw on account of profits; and, although this overdrawing need not necessarily imply bad faith upon the part of the partner concerned, it is important for the auditor to draw attention to it, so that the other partners may have an opportunity of enforcing their rights. Even where the partnership articles do not provide for interest upon either capital or drawings, it would be well to point out that, as a matter of equity, it is desirable that interest should be charged upon any excess of drawings over the authorised amount, inasmuch as these are clearly in the nature of a loan from the firm to the individual partner and should, therefore—as a matter of right—carry interest in exactly the same way, as the law provides that loans from the partners to the firm shall carry interest at the rate of 5 per cent. in the absence of express stipulation to the contrary. Any irregularities of this description should therefore be reported to all the partners; and, as a matter of convenience, it would appear to be desirable that such report should precede the actual closing of the accounts, so that the instructions of the firm may be taken upon the point and given effect to before the audit is completed. It is very desirable for the auditor for his own protection to see that the accounts, after being finally agreed to, are signed by all the partners, whether the partnership agreement demands this or not.

The question of partial audits has already been referred to under the preceding heading. It should be added here, however, that, for the protection of the auditor, it is desirable not only that he should commence with a clear understanding as to the scope and limitations of his partial audit, but, further, that he should draw the attention of any incoming partner to the terms of the audit contract. This question was raised in the case of *McCaul v. McLean*, which came before Phillimore, J., and a special jury in July, 1907. Here the plaintiffs sought damages against the defendant auditor, alleging that it was through his neglect they had lost money by the defalcations of an employee. The defence was that, by arrangement with the then senior partner, the audit undertaken was agreed to be a limited (or partial) audit only; but the said partner had long since retired from the firm, and it was admitted that the defendant had taken no steps to bring this arrangement to the knowledge of subsequent partners.

The action was settled, and thus no express decision on the point at issue was arrived at. There can be little doubt from every point of view, however, that the auditor owes it not merely to himself, but also to his clients, to make it quite clear what he does and what he does not do. In the case referred to, the importance of this point was emphasised by the fact that the annual balance sheets were signed by the auditor as 'certified', and his accounts were rendered for fees for 'auditing'; but even if the accounts had not been signed at all, and the charges had been made in respect of a partial 'audit', or for 'professional services', it would still seem desirable—particularly in view of the decision in *Smith v. Sheard* (*vide* Appendix B)—that there should be a clear understanding in writing as to what the auditor is justified in not checking.

The case of *Charles Fox & Son v. Morris Grant & Co.* may conveniently be considered here as, for all practical purposes, one concerning the liabilities of an accountant who has undertaken what is commonly called a 'partial audit'. In this case the defendants had contracted 'to check' the plaintiffs' 'books' on 'the same lines' as their predecessors for an agreed fee, which was to 'include the drawing up of' the balance sheet. While this arrangement continued, an employee of the plaintiffs committed certain defalcations which he concealed by the falsification of accounts. The accounts falsified were not included in the defendants' scheme of check, and as a result for some years they presented to their clients balance sheets which showed the wrong amount under the heading of 'Cash in hand and at bank'. In the course of the hearing a strenuous attempt was made to distinguish between a contract to 'check books' and a contract to 'audit'. Mr. Justice Lawrence, however, held that it was unnecessary to go into these refinements, that a professional accountant who had contracted to supply periodical balance sheets to his client, ought not to state the 'balance at bank and in hand' therein at a wrong figure, without at least warning the client that he had made no attempt to find out what the true balance actually was. This decision seems to follow very closely the principles laid down in this work, that the professional accountant should be quite candid with his clients at all times, and that where he is not prepared to accept the fullest responsibility for the work that passes through his hands it is for him to explain quite clearly in what respect he regards his responsibility as limited. The decision aroused a good deal of interest at the time, but it is not thought to be sufficiently important to merit inclusion in Appendix B. A very full account will, however, be found in *The Accountant Law Reports*, Vol. LIX, pages 29-36.

THE AUDITOR TO A LIMITED PARTNERSHIP. The Limited Partnership Act, 1907, contains no provision as to audit, and thus the arrangement between the auditor and his client in this case is one determined solely by contract. Inasmuch as the limited partner has a full right to inspect books of account, &c., the responsibility of the auditor appears to be precisely the same as in the case of an ordinary partnership. The proper course would be to hold the balance fairly

between the partners, and to report any infringement of the partnership agreement. In the event, however, of the auditor being appointed by the limited partner (which gives the limited partner the power personally, or by his agent, to inspect the books and accounts), the duties of the auditor appear to be similar to those of one appointed on behalf of creditors either under a formal or informal deed of inspectorship, which are dealt with in the next paragraph.

THE AUDITOR ON BEHALF OF CREDITORS. It not infrequently occurs that a retiring partner who leaves a portion of his capital in the firm, or a creditor who makes an advance to a firm, stipulates that 'Mr. So-and-so shall audit the accounts'. Unless the contrary intention be very clearly expressed the auditor so appointed would act on behalf of both the firm and of the creditor. In such a case it is very desirable that the amount of the fee be arranged beforehand, and it would be wise to have a clear understanding as to the party or parties liable to pay it. In the circumstances the firm could not, of course, remove the auditor without the consent of the creditor; nor, in the absence of a special provision to that effect, could the creditor do so, and in any case he would probably be obliged to indemnify the firm against any extra expense occasioned by his so doing. The position of the auditor, in such a case as this, closely resembles that of the company auditor, except that the creditor would be entitled to the fullest possible information, whereas shareholders have not an equally extensive right. The decision in *Smith v. Sheard* (*vide* Appendix B) is of interest in this connection, because although the jury's findings in the particular case are open to serious criticism the report illustrates the care which must be taken at all times by auditors to be quite certain to whom they look for the terms of their appointment.

AN AUDITOR TO A CLUB OR SOCIETY should be careful to ascertain that his appointment emanates from the body competent to make it under the constitution or rules.

AUDITORS UNDER THE COMPANIES ACT. When the first edition of this work was published there was no statutory provision that the accounts of companies (other than those banking companies registered under the Companies Act, 1879) should be audited, and therefore, although it was very usual for a company by its articles of association to provide for an audit, the relationship between a company and its auditor was one of contract in each particular case, modified possibly to some extent by common law. It is true that Table A applied to all companies whose articles of association did not expressly exclude its operation; but Table A had not the force of a statute, it merely embodied in a convenient form the terms of the contract entered into by those who elected to be bound by its provisions. Accordingly the position of the auditor under the Companies Acts was in those days a matter of some uncertainty, dependent very largely upon the facts of each individual case. It was, however, very usual for articles of association to follow somewhat closely the provisions

of (the 'old') Table A which provided (clause 94) that 'the auditors shall make a report to the members upon the balance sheet and accounts, and in every such report they shall state whether, in their opinion, the balance sheet is a full and fair balance sheet, containing the particulars required by these regulations, and properly drawn up so as to exhibit a true and correct view of the state of the company's affairs; and in case they have called for explanations or information from the directors, whether such explanations or information have been given by the directors, and whether they have been satisfactory; and such report shall be read, together with the report of the directors, at the ordinary meeting'.

It was not until the passing of the Companies Act, 1900 (Section 21), that the appointment of an auditor or auditors became compulsory in the case of every company registered under the Companies Acts.

The whole matter is now governed by the Companies Act, 1948, which takes the place of all previous general company legislation as from 1st July, 1948; all the relevant sections are reproduced in Appendix A.

Section 159 provides that every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that, until the conclusion of the next annual general meeting. It will be observed that an auditor holds his office throughout the meeting at which his report is presented. Although the appointment is for a limited period, it is provided by Section 159 (2) that, subject to certain exceptions, a retiring auditor, however appointed, shall be reappointed without any resolution being passed. As to the exceptions, a retiring auditor is not to be reappointed automatically if he has given the company notice in writing of his unwillingness to be reappointed or if he is not qualified for reappointment. The provisions of the Act by which certain persons are disqualified for appointment are considered below. Section 159 (2) also provides that a retiring auditor is not to be reappointed if a resolution has been passed at the annual general meeting appointing somebody instead of him or providing expressly that he shall not be reappointed. By Section 160, special notice* is required for such a resolution, and upon receipt of such notice the company must immediately send a copy to the retiring auditor. The retiring auditor has the right to make representations in writing to the company with regard to the proposed resolution, and he may request that his representations shall be notified to the members of the company; any notice of the resolution given to members must then include a statement of the fact that the retiring auditor has made representations, and the company must send a copy of the representations to every member to whom notice of the meeting is sent. The representations must not exceed a reasonable length. If the representations are received too late for the company to notify the members, or if the company defaults in notifying the members, the auditor may require that his

* Such a notice must be given to the company not less than twenty-eight days before the meeting at which the resolution is to be proposed, and the company must give its members notice of the resolution not less than twenty-one days before the meeting. If, after the company has received such notice, a meeting is called for a date twenty-eight days or less after the notice has been given, the notice is not thereby invalidated.

representations shall be read out at the meeting. On the application of the company or of any person who claims to be aggrieved by the representations of a retiring auditor, the Court, if it is satisfied that the auditor's rights are being abused to secure needless publicity for defamatory matter, may release the company from the obligation to send a copy to the members or to have the representations read out at the meeting. The Court, in such circumstances, may order the costs of the application to be borne in whole or in part by the auditor. If it is impossible to proceed with a resolution to appoint a new auditor or new auditors by reason of the death, incapacity or disqualification of the person or persons proposed for appointment, a retiring auditor is not, for this reason, to be reappointed automatically. Altogether apart from their rights in the event of a proposal for their removal, the auditors of a company are, by Section 162 (4), entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive and to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditors. The position of the auditor of a company has been greatly strengthened by the provisions of Sections 159 and 160. Should his views be unpalatable to the directors, the latter cannot hope to secure his removal without giving him the fullest opportunity of making his views known to the members of the company. Apart altogether from these provisions, it has, it is thought, always been the rule among the better class of practitioners to refuse to take up appointment in the place of a former auditor without first communicating with the latter and obtaining from him an entirely satisfactory account of the real (as distinct from the ostensible) reason for the non-renewal of his appointment; but it is to be regretted that this entirely commendable procedure did not suffice to secure reasonable fixity of tenure for the office of company auditor. Consequently it was often found that an auditor lost his appointment by reason of the efficiency and zeal which he displayed in the discharge of his duties. The provisions of Sections 159 and 160, which are stronger than the corresponding provisions of the 1929 Act, will therefore, it is thought, be generally welcomed by auditors.

By Section 159 (3), if no auditor is appointed or reappointed at an annual general meeting, the Board of Trade may appoint a person to fill the vacancy. To ensure that the Board shall exercise its powers under this subsection, it is provided that the company shall, within one week of the Board's power becoming exercisable, give them notice of that fact.

By Section 159 (5), the first auditors of a company may be appointed by the directors at any time before the first annual general meeting. The auditors so appointed are, if not removed by the company, to hold office until the conclusion of the first annual general meeting. The company, however, may at a general meeting remove any such auditors and appoint in their place any other persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the

company not less than fourteen days before the date of the meeting. Where it is proposed to remove the first auditors in this way, such auditors have the same rights in regard to representations as auditors appointed at an annual general meeting. If the directors fail to exercise their powers to appoint the first auditors, the company in general meeting may appoint the first auditors, and the directors thereupon lose their power of appointment.

By Section 159 (6), the directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act.

In connection with the powers of the directors and the Board of Trade to appoint auditors, it may be noted that the provision for the automatic reappointment of an auditor, under Section 159 (2) (described above), applies to a retiring auditor, *however appointed*, and therefore applies to an auditor appointed by the directors or by the Board of Trade.

There is nothing to prevent an auditor resigning his office before completing the audit of the year; but in the event of his so resigning, he would of course take the risk of the consequences which might ensue from a possible breach of contract.

It is provided by Section 159 (7) that the remuneration of the auditors, in the case of an auditor appointed by the directors, or by the Board of Trade, may be fixed by the directors or by the Board, as the case may be. In any other case, the remuneration is to be fixed by the company in general meeting or in such manner as the company in general meeting may determine. It has often been found convenient for a company in general meeting to pass a resolution by which the remuneration of the auditors shall be fixed by the board of directors. Before the Companies Act, 1948, came into operation, there was some doubt as to whether this common practice could be supported in law. The terms of Section 159 (7) remove these doubts, and such a procedure is now clearly sanctioned by the law. It is provided, however, by paragraph 13 of the Eighth Schedule that if the remuneration of the auditors is not fixed by the company in general meeting, the amount of the remuneration must be disclosed in the profit and loss account, and thus made known to the members. Any sums paid by the company in respect of the auditor's expenses are to be treated as part of the remuneration for the above purposes.

If the remuneration has not been fixed by the company in general meeting, it may not be possible to determine the amount of the remuneration at the time of completing the accounts. The Council of the Institute of Chartered Accountants has made the following recommendation*:

'In such circumstances an estimated amount should be included in the accounts and any subsequent adjustment, if material in relation to the estimated amount previously disclosed, should be shown in the accounts of the following period.'

The Council has also pointed out that in many cases it may have been

* See 'The Companies Act, 1947—Recommendations of the Council of the Institute on matters of difficulty affecting accountants and auditors, incorporating the joint opinion of counsel: Sir Cyril Radcliffe, G.B.E., K.C., Mr. Montagu L. Gedge and Mr. Walker K. Carter.' The reader will appreciate that the substance of the Companies Act, 1947, is now embodied in the consolidating statute, the Companies Act, 1948.

the practice for the auditors to charge an inclusive fee for auditing and other work, such as professional services in connection with secretarial, accountancy and taxation matters. In such cases, the Council recommends as follows:

'The remuneration—which includes expenses—fixed by the members in general meeting (or disclosed in the accounts when otherwise fixed) should be limited to or specified separately as the remuneration for the auditors' duties under the Act. The fees for other professional services should be treated as a general expense of the business. This will in future necessitate the segregation of the audit remuneration from fees for other services.'

In some cases the company in general meeting may fix the auditors' remuneration and may resolve that the auditors shall be entitled to expenses, leaving the amount of such expenses to be determined by the directors. Since, under Section 159 (7) and paragraph 13 of the Eighth Schedule, it is provided that any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression 'remuneration', it appears to be necessary in such cases to disclose in the profit and loss account the whole of the remuneration including the expenses. The opinion of counsel, obtained by the Council of the Institute (published in the Institute's booklet on the Companies Act, 1947) supports this view.

The auditor, once having accepted office, is presumably under contract to do the necessary work attaching to the appointment, even if he should subsequently regard the remuneration as inadequate; and similarly the company would appear to have no right to refuse the remuneration on the ground that altered conditions had made it excessive. Such matters are, however, naturally more often the subject of mutual arrangement than of the enforcement of strict legal rights.

If it should happen that through oversight or otherwise no remuneration were fixed the matter would be governed by the ordinary rules of contract and the auditor would be entitled to receive a reasonable sum for services rendered. What is a reasonable sum in the circumstances is a matter for a jury to decide.

The question whether an auditor has a lien upon his clients' books for payment of his proper charges sometimes arises. It seems proper to state that an auditor, as such, has no such lien. If, however, the auditor, acting as accountant, has done actual work on the books or accounts by way of improving them he has a lien on such books or accounts for his unpaid fee arising in that respect. It must be carefully noted, however, that where a statute requires that certain books shall be kept in a certain place, no lien can operate to excuse the removal of the books from that place. The registers and minute book of a company would come within the case just mentioned. The subject of lien has been dealt with in *Herbert Alfred Burleigh v. Ingram Clark Ltd.*, which is reported in Appendix B. It was held in *Sockockinsky v. Bright Grahame and Co.* [1938] that an accountant is entitled to retain correspondence and working papers. This case was discussed in a leading article in *The Accountant* on 19th November, 1938.

It is to be noted most particularly that ordinarily the auditor of a company is appointed by the members thereof. Consequently he is the agent of the company, not of the directors, in the performance of

his duties. It is submitted that this is so (bearing in mind the fact that under a later section of the Act the auditor's report is to be made to the *members*) even though in the exceptional circumstances noted above, appointment may be made by the directors. This aspect of an auditor's appointment is usually emphasised in practice by arranging for the motion for appointment of auditors at a general meeting to be proposed and seconded from the shareholders' side of the table. There is, however, no obligatory rule on the point.

RESTRICTIONS ON APPOINTMENT OF COMPANY AUDITORS. Section 161 of the Companies Act, 1948, makes provisions which are designed to ensure both the competence and independence of company auditors. As to competence, it has been pointed out above that, by subsection (1), no person shall be qualified for appointment as auditor of a company unless he is either a member of a body of accountants established in the United Kingdom and recognised for this purpose by the Board of Trade, or is individually authorised by the Board of Trade.

The substratum of an auditor's appointment is, or ought to be, the independence of his position. Section 161 (2) of the Companies Act, 1948, has extended former restrictions on appointment contained in Section 133 of the 1929 Act which were directed to securing that independence. No body corporate may act as an auditor of a company under a maximum penalty for infringement (falling on the body corporate) of £100. Inasmuch as in Scotland a partnership has a legal *persona* it is enacted that a Scottish firm shall be qualified for appointment as auditor of a company if, but only if, all the partners are qualified for appointment as auditor thereof. This provision reflects the conception of personal responsibility to form a personal opinion on matters brought under audit which falls on the auditor, and it enables members of a company in case of need to pin down a definite liability on a particular person or persons appointed by them. Subsection (2) also disqualifies for appointment as auditor an officer or servant of the company and (except where the company is an exempt private company) a person who is a partner of or in the employment of an officer or servant of the company. The proviso in favour of exempt private companies is an important exception to the general principle and presumably reflects the traditional policy (so largely reversed in recent years) of interfering as little as possible with the carrying on of private business so long as the public interest does not suffer. The dispassionate observer, however, cannot forget that the interests of creditors may be affected by accounts as much as the interests of company members, and to that extent the exception seems distinctly anomalous. The disqualification of a person who is a partner of or is in the employment of an officer or servant of the company is an extension of a similar provision in the 1929 Act, with the important distinction that the word 'servant' did not occur in the earlier provision. It has been felt that this provision may give rise to some uncertainty, in view of the various duties which are often undertaken by accountants or their partners or employees. In the opinion of

counsel*, the registrar of a company is not an officer of the company and a financial adviser is not a servant of the company, unless, in either case, the contract is such as to give the company the right to control the activities of the individual in question. Counsel also expressed the opinion that neither a liquidator nor a receiver of a company is an officer of a company for the purposes of this subsection, but they drew attention to the fact that the expression 'officer' is defined in the Act as including a 'manager'. (Section 455 (1).) Accordingly, in their opinion, a receiver and manager is an officer of the company. Finally, they expressed the opinion that there is nothing to prevent an accountant whose employee acts as director, secretary or otherwise as an officer of the company, from acting as auditor of the company.

If a person is disqualified under Section 161 (2) from acting as the auditor of a company, he is also, by subsection (3), disqualified from acting as auditor of any other company which is a member of the same group—i.e. any company which is the holding company of, or subsidiary of, or fellow-subsidiary of, the first company.

It may finally be remarked that a resolution appointing 'A.B. & Co.' auditors of the company in effect appoints all the partners for the time being in the firm 'A.B. & Co.' In the event of one or more partners retiring it is thought by some that the appointment would rest with those who are entitled to the use of the firm name. In this connection reference may usefully be made to the case *Taylor and Others v. Eustace Miles Food (1921) Ltd. and Others*, which is reported in Appendix B.

The practice of appointing a firm was criticised by Mr. Justice Humphreys in his summing-up in *Rex v. Hinds, Musgrave and Steven (1950)*. The relevant extract from the summing-up is the following:

'I think it right to say this (although it will not affect, and is not intended to affect, your verdict) that it does call for consideration by the authorities whether this system of appointing a firm of auditors is a satisfactory one. . . . It may be that this case has shown that it is not very satisfactory, because you do not get what everybody desires—the personal assurance of an individual who is an expert that this is right. It turns out that all you get is, instead of a personal assurance, that that expert, it may be, accepted somebody else's view. It is very difficult to fix responsibility in that case. That is another matter. But in this case what he did was perfectly right and proper. It is quite right that the auditors should be a firm. They are allowed to be a firm, although the legislature has been careful to say that you must not have a limited company as auditors. There is a special provision to that effect in the 1948 Act. A limited company cannot be auditors. This shows that the legislature has considered how undesirable it is.'

AUDITORS AND NATIONALISATION. After the General Election in the summer of 1945, it became certain that a number of basic industries would be transferred to public ownership. It was immediately seen that the process of nationalisation would create problems in which the accountancy profession would be concerned. The first question was whether the various statutory bodies would be required to keep accounts that would satisfy commercial standards of efficiency, and whether provision would be made for publishing satisfactory and

* See 'The Companies Act, 1947', published by the Institute of Chartered Accountants.

informative annual accounts. Secondly, it was asked whether the accounts of the various public bodies would be subject to audit by independent professional auditors. The third matter was, for many members of the profession, a more personal one: the transfer of a very large number of undertakings to public ownership must eliminate a great number of individual audits.

The first question has been settled by provisions relating to accounts which are contained in the relevant Acts of Parliament. Thus, Section 31 (1) of the Coal Industry Nationalisation Act, 1946, requires that 'the Board shall keep proper accounts and other records in relation thereto, and shall prepare in respect of each financial year of the Board a statement of accounts in such form as the Minister may direct, being a form which shall conform with the best commercial standards.'

There are similar provisions in the Civil Aviation Act, 1946, the Electricity Act, 1947, the Transport Act, 1947, and the Gas Act, 1948, but it may be remarked that the Transport Act omits the requirement of conformity with the best commercial standards.

The accounts of the nationalised industries are considered under their appropriate headings in Chapters IV and V.

With regard to the audit of the accounts of the statutory bodies set up under nationalisation and the impact of nationalisation upon auditors, it was felt desirable to set up an Accountants' Joint Parliamentary Committee, composed of representatives of the following professional bodies:

The Institute of Chartered Accountants in England and Wales.

The Society of Incorporated Accountants and Auditors.

The Society of Accountants in Edinburgh.*

The Institute of Accountants and Actuaries in Glasgow.*

The Society of Accountants in Aberdeen.*

The Association of Certified and Corporate Accountants.

In the words of the president of the Association of Certified and Corporate Accountants in his address at the annual general meeting of the association in 1947:

'the committee has endeavoured to secure (1) that the accounts of the various boards and commissions to be set up by Parliament should be subject to audit by independent professional accountants; and (2) that, as far as possible, the effects of nationalisation on firms of accountants who have in the past audited the accounts of the undertakings which have been or will be nationalised should be mitigated.'

The viewpoint of the profession has been made known to the representatives of the various government departments and of the nationalised undertakings by deputations from the Joint Committee.

The Acts of Parliament by which the various statutory bodies have been set up require, in every case, that the accounts shall be audited by an auditor or auditors appointed by the appropriate Minister. The stages by which progress has been made towards official recognition of the importance of independent professional audit can be clearly traced in the legislation of the years 1946 to 1948. The original draft of the New Towns Bill (afterwards the New Towns Act, 1946), contained

* Now amalgamated as the Institute of Chartered Accountants of Scotland.

a provision that the accounts of the Development Corporations which were to be set up should be audited by district auditors. This was replaced by an amendment requiring audit by an auditor appointed by the Minister. An attempt was made to secure a further amendment requiring that the auditor should be a member of one of the recognised professional bodies, but this was withdrawn upon an assurance being given that it was the Minister's intention to appoint qualified persons as auditors.

When the Coal Industry Nationalisation Bill was before Parliament, a similar assurance was given that the Minister would appoint competent, reputable, and fully experienced and qualified auditors.

The assurances so given have been honoured and it has become an established practice to appoint independent firms of professional accountants to act as auditors of the various statutory bodies.

An important advance can be seen in the audit provisions of the Electricity Act, 1947, and of the Gas Act, 1948. Both these Acts provide that the accounts of the various bodies shall be audited by auditors to be appointed by the appropriate Minister, but they also provide (unlike the earlier Acts) that no person shall be qualified for appointment as auditor unless he is a member of one of a number of specified professional bodies. In the case of the Electricity Act the specified bodies are those represented on the Accountants' Joint Parliamentary Committee, and, in the case of the Gas Act, the same bodies, with the addition of the Institute of Chartered Accountants in Ireland. In observing the chronological sequence of events, it is interesting to notice that in the Industrial Assurance and Friendly Societies Act of 1948 the professional bodies of which the auditor must be a member are also specified by name. As regards the Companies Act, 1948, it will be remembered that the professional bodies are not named in the Act itself, but are designated by the Board of Trade.

It is a matter for satisfaction to the profession that the importance of audit by independent and competent professional auditors has been fully recognised by those responsible for the various nationalisation schemes. On the other hand, the position in regard to the displacement of auditors and loss of audit work due to nationalisation is less satisfactory. The substitution of a limited number of statutory bodies for a large number of independent undertakings has led to a serious loss of work for those professional firms who formerly acted as auditors of the independent undertakings. To some extent, the hardship has been mitigated by the employment of qualified accountants in the internal audit departments of the various statutory bodies. Many of these accountants were formerly employed by professional firms who were auditors of the undertakings now taken over by the statutory bodies. In some instances also, professional firms are employed by the statutory bodies to audit sections of the accounts, but it would seem that their position is more akin to that of internal auditors than to that of the professional auditors appointed by the Minister under the statutory provisions. For further details regarding the audit of the nationalised industries the reader is referred to Chapters IV and V.

Despite the creation of internal audit departments and the employ-

ment of local professional firms, it is beyond doubt that many members of the profession have suffered financial loss by reason of nationalisation. Proof of this is found in the annual report of the National Coal Board for 1947, in which it is stated that the total cost of the internal audit staff of the Board, together with the fees payable to professional firms of accountants, including the auditors appointed by the Minister, is less than the audit fees paid by the Coal Industry before nationalisation. It is noteworthy that no provision has been made for compensating professional firms for loss of audit work, and this has led to some hardship. The position of auditors in relation to nationalisation has, however, not yet been stabilised, and it would be rash to make predictions.

CHAPTER II

AUDITING UP TO THE TRIAL BALANCE

THE OBJECT OF AN AUDIT. The object of an audit may be said to be threefold:

- (1) The detection of fraud.
- (2) The detection of technical errors.
- (3) The detection of errors of principle.

On account of its intrinsic importance, the detection of fraud is clearly entitled to be considered an object in itself, although, as will be obvious, fraud can only be concealed by the commission of a technical error, or of an error of principle. It will be appropriate, therefore, to combine the search after fraud with search for technical and fundamental errors; but it can never be too strongly insisted that the auditor *may* find fraud concealed under *any* item he is called upon to verify. His search for fraud should therefore be unwearying and constant.

The detection of fraud is a most important portion of the auditor's duties, and there will be no disputing the contention that the auditor who is able to detect fraud is—other things being equal—a better man than the auditor who cannot. Auditors should therefore assiduously cultivate this branch of their functions (probably the opportunity will not for long be wanting), as it is undoubtedly a branch that their clients will most generally appreciate. It must be remembered, too, that the auditor who, through negligence in the performance of his duties, fails to discover the existence of fraud may be made liable to make good to his client the whole extent of the loss flowing therefrom.

It has been asserted by some that the whole duty of the auditor is to ascertain the exact state of his client's affairs upon a certain given date. This is, in effect, the same thing as saying that he is responsible only for the correctness of the balance sheet. In the case of limited companies, auditors are, by the Companies Act, 1948, specifically required to report on the profit and loss account as well as on the balance sheet. Even in other cases, the assertion is open to considerable doubt, as the extent of an auditor's duties depends entirely upon the terms of the express or implied contract between himself and his client, and, in any event, the balance sheet cannot well be verified without a proper examination of the revenue account, which in its turn involves a complete examination of the books.

Speaking quite generally it is the duty of an auditor (unless the scope of his audit be specifically restricted by the terms of his appointment) to satisfy himself as far as may be reasonably possible (a) that the whole of the income has found its way to the credit side of the revenue account; (b) that all expenditure recorded in the revenue account has been actually incurred, under proper authority; (c) that the assets in the balance sheet actually exist and are valued on proper

principles; (d) that all liabilities (actual and contingent) are included in the balance sheet; and (e) that any distribution of the disclosed surplus is in accordance with the constitution of the business.

It is, further, in the highest degree necessary that the auditor, before commencing his investigation, should thoroughly acquaint himself with the general system upon which the books have been kept; and having thoroughly made himself master of the general system of accounts in use, the auditor should look for its weakest points. 'Where is fraud most likely to creep in?' he should ask himself; and, if he can find a loophole, let him be doubly vigilant there. But never let him for a moment suppose that, because he sees no opportunity for fraud, none can exist. To the intelligent auditor who has grasped his system thoroughly, it is generally practicable to dispense with *some* portion of the detailed checking. To what extent this can be done with safety must always remain a question for each auditor's own intelligence and experience to answer, in the light of the internal check which the client's own book-keeping system affords. It must be added that the auditor must take the risk of any consequences that may ensue from omitting detail; but, so far as the matter can be dealt with in a general treatise, its solution will be sought after in these pages.

Before leaving this subject, it may, perhaps, be well to add that under the expression 'mastery of the general system' are included a perusal of the partnership articles, memorandum and articles of association and registered contracts, deed of settlement, special Act of Parliament, statutory regulations, and any and all other documents affecting the general constitution of the concern under review.

✓ **ADVANTAGES OF AN AUDIT.** The question has been raised from time to time as to what advantages may reasonably be expected from a proper professional audit of accounts. In addition to those mentioned in the preceding paragraph, as coming under the head of the primary objects of auditing, it may be pointed out that the proprietor or proprietors, of a business will not only have the advantages of having placed before them an accurate statement of their affairs, together with a profit and loss account showing how this position has been arrived at; but that they will also have available certified accounts as to profits which cannot fail to be of the greatest convenience, either in the event of their wishing to sell the business to a private trader or firm, or to a limited company, or in the event of one of the partners dying or wishing to retire. In all these circumstances the importance of a thoroughly reliable statement of profits cannot be over-estimated, and the convenience it affords—as well as the enhanced price which can be obtained in the event of a sale—will in all normal circumstances more than compensate for any slight expense which the audit may have originally involved. So far as private firms are concerned, an efficient audit possesses the further advantage that, by reason of its ensuring the periodical preparation of reliable accounts, it tends to minimise the risk of partnership disputes, with all their attendant annoyance and expense. Accurate

accounts are also valuable as preventing an over-assessment for income-tax, or enabling tax over-paid in error to be more easily recovered: they are also of the greatest possible value to both sides in compensation cases.

In the case of companies, the audit assumes a slightly different application owing to the special nature of the contract and to the statutory regulations affecting the matter. The company auditor is not expected to act as the financial adviser of the undertaking—a position that is frequently thrust upon him in connection with private audits—his duty being rather that of an auditor appointed in the interests of sleeping or 'limited' partners. It devolves upon him to examine the accounts of their stewardship, prepared by the active partners—i.e. the directors—and to report to the shareholders whether in his opinion those accounts give a true and fair view of the profit or loss and of the state of affairs, or in what respects they fail to do so.

In addition, it may be pointed out that various cases reported in Appendix B to the present work show that in the event of an auditor, through his negligence, failing to discover fraud or embezzlement on the part of the employees of the client, or if he should through negligence fail to warn the members of a company that the funds thereof are being misapplied, he may be held liable in damages for the amount lost as a result of his negligence. This liability involves, of course, a corresponding benefit to the persons in whose favour the liability accrues, and is consequently a factor that ought not to be lost sight of in weighing the advantages of an audit. It is, however, perhaps hardly necessary to add that the auditor does *not* 'insure' the honesty of his client's employees: on the other hand, many professional accountants insure themselves against losses arising from errors of judgment or negligence on the part of themselves or of their own clerks.

STEPS PRIOR TO AUDIT. One of the very first steps to be taken after appointment and before taking up the actual duties of an audit is to obtain a list of all the books kept by the client, accompanied if possible with a statement of the part which each book plays in the accounting scheme and the name of the clerk in charge of each book.

The list should either be prepared by the client himself or should be approved by him after preparation. There is a very good reason for this requirement. The audit must evidently be based on the books and the information and explanations for which the auditor asks in the course of audit refer to the matters which come to his notice from an examination of the books. Hence if any books exist of which he is unaware, the information which the auditor requires from his client and his client's staff may be incomplete and thus serious errors in the final accounts may pass undetected. In the case of companies, auditors are required by the Companies Act, 1948, to state in their report, whether, in their opinion, proper books of account have been kept by the company. They are also required to state whether the company's balance sheet and profit and loss account are in agreement with the books of account and (in the case of branches) returns. Obviously

the auditor runs a serious risk if he allows any of the books to remain unexamined, and for that reason, in the case of companies, the taking of an agreed list of all the books is of the utmost importance.

In many cases adequate preparation is made by the client's staff for the coming of the auditor; but where this standard is not reached it may be necessary to issue a brief list of instructions showing the work which should be done before the commencement of the audit. Such a list is the following:

(1) All postings should be completed, all additions inked in, all balances extracted, and the trial balance agreed.

(2) Vouchers for all payments, invoices supporting purchase books and documents supporting all entries in journals and other books of original entry, should be arranged in order and available.

(3) If possible, the cash in hand at the date of closing the books should be paid into the bank or reduced to small dimensions by such deposit if complete payment-in be not feasible. The cashier must have his books written-up to the date of the actual audit, and the vouchers ready. The banker should be asked to certify the balance(s) direct to the auditor.

(4) A complete inventory of the stock—priced, extended, added, and duly certified—should be ready.

(5) All bonds, bills, deeds and other securities should be ready for production when called for by the auditor and a list thereof should be prepared. If these documents are in the custody of the banker, he should be asked to certify the fact direct to the auditor.

(6) A list of all overdue accounts, showing the provision (if any) which it is deemed necessary to make against possible loss, should be prepared.

(7) A memorandum should be kept of any other matter to which it is thought desirable to call the auditor's attention.

(8) A draft balance sheet and profit and loss account should be prepared.

✓ **METHOD OF AUDIT.** Audits are either 'continuous' or 'periodical' and the two plans are compared below.

✓ **THE CONTINUOUS AUDIT** is one which is commenced and carried on before the close of the financial period to which it relates. An audit which is fully continuous involves the attendance of the auditor's staff at the client's office throughout the period under review. In other cases that attendance takes place at frequent intervals and it is obvious that the various degrees of continuity of audit shade off into one another. The advantages of the continuous audit may be said to be: (1) The examination occurs sooner, and consequently any errors committed are more quickly detected and rectified; (2) the periodical visits of the auditor keep the book-keepers closer up to their work; (3) a more detailed audit is practicable; (4) the audit can be completed soon after the closing of the books, without unduly hurrying the examination. On the other hand, there is always a danger of items that have been checked by the auditor being altered (either

ignorantly or fraudulently) before the final audit; and it is therefore necessary that the clerk in charge of a continuous audit be very wide awake, and have a very clear idea of the system under which he is working, with a view to countering the danger referred to.

It has been found a good plan to adopt a special 'tick' for the verification of all figures upon which a correction appears, as, if this plan is adopted, a correction made after the tick has been affixed will be more readily discovered. It goes without saying that the difference in the two ticks should be as slight as possible, and the book-keepers should *not* be told what the difference implies.

THE PERIODICAL OR COMPLETED AUDIT is one which is begun only after the close of the financial period to which it relates. It lacks the advantages which have been stated to attach to the continuous audit, but on the other hand, its execution involves less organisation on the part of the auditor and the danger of fraudulent manipulation of the books after audit is less. It will be clear to the reader, however, that all but the smallest audits must almost necessarily be, in some degree, continuous.

The risks involved in leaving the books in the hands of the book-keeper during the audit are undoubtedly very considerable; but, so long as these difficulties are not lost sight of, there is but little doubt that common sense and a general alertness will save the auditor from this—as well as many another—danger. Moreover, where the auditor himself closes the books—and this will not infrequently be the case in small audits conducted continuously—it should be difficult for fraud on the part of the staff to escape detection altogether.

It would be well to mention here the extreme importance of *completing* each item of the audit as soon as possible after it is begun. Extensive frauds have escaped detection because the auditor checked the balances of a ledger one day, and the additions of such balances on the next—some of the items having been altered in the meantime. It will be obvious that had the additions been checked on the same day as the extraction of the balances, and a note taken of the total, such a fraud would have been impossible.

What may be described as the 'ideal' audit is one combining the two modes of investigation just described. It is sometimes attained by the employment of two independent auditors, one performing a continuous and the other a periodical audit; but more frequently the continuous audit is done by 'staff' auditors, or by the client's ordinary employees under a good system of internal check. In the case of companies registered under the Companies Acts, the auditor has 'a right of access *at all times* to the books and accounts and vouchers of the company': this right would appear to involve a corresponding duty in all cases where such a course seems necessary in the interests of the company.

THE ORGANISATION OF AN AUDIT. Since an audit is intended to establish the correctness of the accounts coming under examination it follows that the audit itself must be conducted on a scheme of

organisation which leaves no loophole for mistake as to its scope and methods. It is therefore necessary to arrange (a) what work is to be done; and (b) who is to do it. Thereafter it is essential (c) that a record of the actual performance of the work by the person designated should be preserved and (d) that a systematic record of the queries arising and of the manner in which they were cleared should be kept.

Discussion of the first of the matters named must centre around the audit note-book. It is clear that there must be some detailed record of the work performed, unless an audit is to degenerate into an uncontrolled and undocumented browsing over the field of the accounts. Broadly speaking there are three plans, each of which has its advocates. First then, the clerk in charge may be provided with a printed form of book containing an exhaustive series of headings, to comprise all those which might conceivably arise on any engagement. The clerk provided with such a form can reach his list of duties to be performed by a process of exclusion. The author has published an 'audit note-book' on these lines the demand for which is sufficient to prove that the use of such a book is very general among the profession. A slightly different form of book is illustrated on page 35.

It will be seen that such a book differs from the specimens already described in much the same manner as a ledger differs from a journal. Instead of a separate book being employed for each audit, a folio of the audit note-book is devoted to that purpose, and it will further be seen that the specimen ruling shown provides for a monthly audit extending over two years.

As this is an office book, rather than a portable one, it is written up from memorandum books, one of which is devoted to each audit, or it may be written up from the diaries of the audit clerks. In any case, however, it would seem that some kind of audit note-book would require to be kept for each separate matter, in which memoranda and queries might be recorded; but it will be obvious that, if the audits are fairly uniform in character, the information afforded by the above book would be of the greatest convenience to principals in supervising the work of their various audit clerks, and generally ascertaining the state of the various matters in hand. It may be added that a card diary provides a very convenient means of recording the state of current audits.

In some offices it is customary to maintain as a kind of preface to all these stereotyped forms of audit note-book a set of general instructions common to all audits, presumably in order to remind all clerks of the general scope which it is expected their work will cover. A specially complete specimen is given below:

INSTRUCTIONS FOR AUDIT

1. In commencing a new audit you should obtain a list of all the books kept, and of all persons authorised to receive or pay money and order goods.
2. In the case of a joint-stock company, examine the articles and board minutes respecting the receipt and payment of money, and the drawing of cheques, acceptances, &c.

3. Ascertain and take note of the general system upon which the books are constructed, and the plan of checking the correctness of the accounts paid, and whether exclusively or generally by cheques.

4. Report if the accounts and vouchers have been submitted to the board of directors by an account committee or otherwise, and whether they have been systematically checked and certified; and note any discrepancies.

5. Examine all the items in the cash book with the bank pass books or statements and vouchers, and put your usual audit initials in the pass book or statement and to every item in the cash book. Ascertain if the bankers' pass book is frequently entered up and examined, or, if the bank issues loose-leaf statements, ascertain whether these are obtained from the bank and examined at regular intervals.

6. Note any unusual or extraordinary payments or receipts.

7. In regard to the payments for wages and petty cash, note any unusual items, and see that vouchers for all payments are kept and produced.

8. Report whether a rough cash book is kept, and whether the fair cash book is regularly and punctually posted and balanced, and if the balance is checked.

9. Report also if the entries in the fair cash book are in arrear, on account of the current year; and if so, to what extent, and why.

10. In all cases where branch establishments are included in one business you will be careful to examine into the mode of bringing the returns of work, accounts, and expenses to the head office.

11. Examine all the day books, and see that the proper returns of purchases and sales are made by each department, and that the bought and sold books are properly entered up; that the invoices are properly checked as to quantities and prices; obtain a declaration, or otherwise satisfy yourself, that every liability of the year is brought into account.

12. The postings in the personal ledgers must be checked from the bought and sold day books and the cash book, and also from the bill books and journal.

13. The postings in the nominal or impersonal ledgers must be checked from the journalising of the bought and sold day books, the bill books, the invoice books, and the cash books, and the mode and correctness of the journalising must be carefully proved.

14. Examine the bills receivable and bills payable books, and note any item of past due, renewed or dishonoured bills, and make list of same and of the securities, if any.

15. Examine the entries and transfers passed through the journal, and check the postings; and although you are not held responsible for the details of classification, it is desirable you should make any suggestions required, and note any discrepancies, especially in relation to the division of expenditure on account of capital and profit and loss accounts respectively.

16. Examine the share register, and see that the amounts received for calls agree with the entries in the bank pass books or statements, and that they are correctly posted to the credit of the respective shareholders in the share ledger; that all transfers from the transfer deeds are duly stamped and entered in the register of transfers; and also that the amount of the subscribed and paid-up capital and arrears corresponds with the balance sheet.

17. Examine the register of all mortgages on the company's property, and all debenture bonds issued, and note and check the amount of capital paid in advance of calls, and of the receipts and payments in respect thereof with the bank pass books or statements.

18. In the accounts of stock-taking see that all stock sheets and returns are duly signed by the heads of departments, and that the same are correctly carried forward to the general stock account; and ascertain and note whether goods finished or in progress are taken at cost price or otherwise; also report whether in large concerns an independent check clerk or valuer has verified the stock returns in regard to prices and quantities.

19. In checking the profit and loss account, note whether the usual and proper deductions are made for wear and tear and depreciation, and for recouping of capital on works or premises held on short leases.

20. Take care that in the balance sheet no additions are made to expenditure on capital account, except such as are duly authorised by the board of directors, and note the distinction between new works and mere replacements.

21. Ascertain whether the conveyance deeds and other securities specified in the agreement of purchase and articles of association have been duly executed, and the sums paid by the company on account of purchase have been duly endorsed thereon or otherwise acknowledged to the satisfaction of the solicitors or board of directors; also that the existence and safe custody of these documents have been duly certified; ascertain by application to the bankers the correctness of any balances, bills, or securities lodged with them.

22. Ascertain the correctness of the cash balances, bills, and other securities in hand, and take note of every exceptional transaction.

The second alternative is for the principal to settle, on the occasion of each successive audit, a programme of audit to be observed by the clerk in charge. In the construction of such a document the principal will no doubt be guided by the previous programme but the advantage claimed for the plan is that it provides a definite opportunity for the review and reconsideration of the plan of audit, thus preventing the work from getting into the groove which is so notoriously destructive of efficiency. A programme of this kind can be either a manuscript document or can be adapted from a general printed form.

On the other hand, it has been suggested that 'if a competent clerk is sent to undertake an audit (and none but competent clerks *should* be sent), it is much the better way to leave him unfettered with printed instructions, but allow him to go thoroughly into the whole system in operation, and from the nature of such system, and from what he sees, let him outline his own method of procedure. By this means there is not so much danger of his getting into a semi-careless groove of working, and moreover he feels that more responsibility is placed upon him, which acts as an incentive to do the work more thoroughly than would be the case were he working to "rule of thumb". There is doubtless something to be said upon this side of the question; but if so much be left to the clerk it is a little difficult to see what the principal is expected to do himself.

We are thus brought to the third form of audit note-book, namely, the book which is provided in blank for the clerk in charge, who writes up his own programme and record. This plan has been criticised above and it is obviously suited only to those cases where the clerk is of a particularly responsible order. It must be remembered too that the plan carries with it the distinct danger that the principal himself, who can never escape ultimate responsibility, may get out of touch with the engagement and realise, when too late, that a fatal omission or blunder has been committed.

We have spoken throughout of a 'book', but a plan which has been growing in popularity of recent years is to place all the papers relating to an audit upon an audit 'file', one for each periodical engagement, so that ready reference may instantly be made to *all* the papers relating to any particular year's audit. Provided that for each

[illegible]

client there be kept also a 'permanent' file containing such matters as articles of association affecting each successive audit this plan has evident advantages.

To sum up, then, the matter may be stated thus: At the commencement of an audit the principal should, if possible, go over the ground personally, and decide what work requires to be done. A list of such work (together with any other special notes that may seem desirable) should be entered in the audit note-book, which should be ruled in columns, so that the initials of a clerk against any item may clearly show that he is responsible for the correctness of that item for the period named at the head of the column. In most cases it is practicable to keep books ready printed which, with but slight alteration, will answer the purposes of any audit; but there will usually be some special circumstances connected with each audit that distinguish it from others, and these circumstances will usually involve some modification of the customary routine relating to that class of accounts.

Some kind of definite system is undoubtedly preferable to leaving things too much in the hands of the audit clerk, as there is, in the latter case, always a danger, either of dissatisfying the client, or else of leading him to prefer a change of principals to a change of clerks, if one of the two be inevitable. For this reason, if for no other, the principal should always endeavour to keep the reins of every audit in his own hands, or, at least, out of the exclusive control of any one audit clerk; for, although objection may legitimately be taken to the latter being kept at a continual game of 'General Post', it cannot be denied that it is a mistake invariably to send the same clerk to the same audit.

Before leaving the subject of audit note-books, it may be remarked that in the course of the *London and General Bank* case the importance of a systematic record of queries was emphasised by the late Lord (then Mr.) Justice Vaughan Williams; and that pointed reference was more than once made by the Court to the careful excellence of the detailed records kept by the auditor in the *City Equitable* case; those records evidently impressed the judges in favour of the auditor and the moral is obvious.

With regard to the allocation of responsibility for duties, there is little need to emphasise in this book the importance of arranging a chain of responsibility from the youngest junior up to the auditor himself. It is obvious that every person engaged on the work will give better service if he is quite conscious of his personal contribution to the general scheme. The important point, which is emphasised here, is that the clerk actually in charge of the audit should be impressed with a sense of his own responsibility, and all the assistants working under him should be encouraged to seek his assistance in any difficulties which crop up. It is considered to be very desirable that on each occasion when an annual engagement is taken up, the principal himself should visit the office of the client in order that he may be able to appreciate any new conditions which have come into being; it is further thought to be very desirable that where a new clerk-in-charge

is to be put on to the work, the principal should pay him the compliment of giving him a definite introduction to the client and the client's principal assistants. A point like this last may seem to have only a remote connection with auditing, but many auditors have proved by experience the advantages to be gained through attention to such points of detail.

The audit papers should contain a permanent record of the names of the clerks responsible for the performance of each portion of the work. This preferably takes the form of the actual initial, against each item of the audit programme, of the clerk concerned, with the date on which the work was done. These initials then act as a visible indication of the state of completion of the audit as a whole and they also furnish the means of definitely pinning down responsibility to a given individual.

The record of queries raised is one of the most important points connected with any audit whatever, and a clerk who is able to take satisfactory notes in this respect is a person who will quickly be regarded as a treasure by his fortunate employer. It is not every clerk who is able to realise that the query which is vivid in his mind at the moment when he is taking the record can only be appreciated by the principal as a consequence of reading (perhaps long after) the words which are then being written. Omission of any relevant detail may operate to prevent a proper appreciation of the matter on the part of the principal. It is usually found to be best that these queries should be written on the left-hand half of sheets of paper so that the right-hand half can subsequently be used for a record of the manner in which the query was cleared, to be authenticated by the initials of the person so clearing it. The query itself should indicate quite clearly the book on which the query arose and the particular audit step which revealed it. Thereafter should follow precise details of the exact matter brought into question and if there is a choice between using too many words and too few it is much better to err on the side of verbosity. Nothing can be more annoying to the principal whose duty it is to scan such queries than to find such a note as 'addition wrong'. Obviously such note should inform the reader (a) what figures appear; (b) what figures should appear and, usually (c) what effect the error has in the ultimate result. The notes which are now under discussion should be systematically arranged and, as they are cleared, it is a good plan to pass a perpendicular line in coloured ink through each one. It is a great mistake to imagine that notes which are cleared can be destroyed; it may afterwards be of vital importance to produce evidence that a particular query was raised.

THE SYSTEM OF INTERNAL CHECK. The theoretical responsibility of the auditor extends ultimately to every entry in the books of account; but it does not follow that it is either necessary or possible to examine every entry in detail. Certain portions of the examination, notably those where great numbers of entries all of the same kind recur, may often be dealt with by means of test check. The extent to which advantage may be taken of this principle depends almost

entirely on the efficiency of the existing system of internal check. Internal check may be defined as such an arrangement of the accounting routine that errors and fraud are automatically prevented or discovered by the very operation of the book-keeping itself. Opportunity will be taken at a later point to expound more fully the principles upon which such an internal check must rest. It is desired at this point to call attention to the necessity for inquiring into the existing scheme in order that the auditor may form an opinion whether, and to what extent, he is justified in relying on its operation. If he is satisfied that a good system is in existence and if he is further satisfied that the routine laid down is faithfully followed, then, it seems, he has reasonable ground for relieving his staff of some portion of the detail which would otherwise fall to their lot. It need hardly be said that a constantly watchful eye must be kept on the maintenance of the system and the auditor must be on his guard lest, in course of time, loopholes should appear through which the perpetration of fraud might be made possible.

Internal audit must be distinguished from internal check. The latter is inherent in the book-keeping system itself, and operates at the very moment when the entries are made. Internal audit, on the other hand, is something which is imposed on the book-keeping after the entries have been made. It consists in the appointment by the client of officers in his own employment charged with the duty of checking the entries which have been made by the ordinary book-keeping staff. The remarks which have been made as to the reliance to be placed by the auditor on internal check apply to a great extent to internal audit; but it must be pointed out that no system of internal audit can properly take the place of internal check because internal audit cannot discover errors until after they have been committed nor, perhaps, until after some irreparable damage has been caused.

AUDITING BY TESTS. Mention has been made above of the fact that the auditor may take advantage of the existence of a good system of internal check to relieve himself of the labour of examining every separate entry. It would be a mistake, however, to suppose that a mere random selection of entries for detailed examination may be substituted. The 'test' ought to be more scientific than that. The items to be tested ought to be so chosen that they cover the whole field to be examined or, in other words, they ought to be, in the statistical sense, fair samples of the whole group. A little consideration will show that the 'spread' of the sample ought to take into account the fact that there are (a) entries relating to transactions of various kinds; (b) different officers engaged on the various sections of the work; (c) at all times throughout the year. These three elements should accordingly be given full weight in the selection of samples, so that all the classes of entries are fairly covered and so that every officer's work comes under due consideration, having further regard to the fact that the honesty and efficiency of those officers ought to be tested over the whole period covered by the audit.

A danger connected with test audits must be mentioned. If there

be 10,000 entries and if every one be examined, the discovery of one error would (unless the circumstances were exceptional) be a very small affair. But if the 10,000 should be subjected to a one per cent. test, then the discovery of one error would be very serious indeed, for it would lead to the inference that there are probably 100 errors in 10,000. Where the percentage of items checked is very small there is an obvious weakness in such an inference, and attention is called to the point in order to remind auditors to use the most careful discretion in fixing the statistical standard to be observed in their tests.

THE AUDITOR'S CHECK MARKS. It is advisable that in every office there should be a definite rule with regard to the meaning to be attached to check marks of various kinds. Two broad rules are in general operation. In some offices the clerks are encouraged to cultivate check marks or 'ticks' which can be recognised as having been made by given individuals. There may be conveniences about this plan but it is suggested that the identity of the person who made a given mark should be discoverable from an audit note-book if properly kept. In other offices there is in operation what appears to be a superior plan. Here the position and shape of the 'tick' connote not the person who formed it but the nature of the verification which the mark is intended to substantiate. It is unnecessary to lay down any universal rules as to the shape of these marks, but it does appear desirable that in each office some uniformity should be cultivated. In such an event a change of assistants in any particular engagement does not entail an unsightly mixture in the check marks displayed on the face of the books. Emphasis is to be laid on the matter of position in regard to the marks. For example, it is usually understood that the 'tick' which verifies a posting to a ledger appears on the left-hand side of the figure which has been so checked, while the mark for the comparison of that figure with a voucher appears on the right-hand side. Additions are often dealt with by a tick beneath the total and if any cross-cast is involved its verification is conveyed by the appearance of a crossing on the original addition mark. The principle of this rule may be extended to cover such matters as summarisation. Where subsidiary totals are carried to a final summary it is suggested that a mark be placed against the former, on the right-hand side thereof, consisting of a single stroke which slopes upwards from left to right. When the figure arrives in the summary it can be marked there by a similar stroke, which, however, slopes downwards from left to right and appears on the left-hand side of the final figure. Where each mark, in this way, has a definite meaning the importance of uniformity of practice throughout an office will be appreciated.

THE PREVIOUS BALANCE SHEET. It is important that the auditor should see that he begins his investigation at the exact point where the previous investigation left off—that is to say, the opening balances of the period under review should in all cases be checked and agreed with the previous balance sheet. This applies whether or not the accounts for the previous period were checked by the same auditors.

By way of showing the extreme importance of adopting this somewhat obvious precaution it may be added that, some years ago, a case of somewhat extensive fraud occurred, extending over a long period, which might have been discovered at any time, had the auditors checked the opening balances with the previous year's books. In these days of loose-leaf ledgers this point is perhaps of greater importance than it ever was before.

It is very generally conceded that no auditor can be made liable for the acts or omissions of his predecessor in office; but this rule must, of course, be applied strictly, and an auditor who adopts and perpetuates the mistakes of his predecessor would not on this account alone escape the consequences of his own negligence. It is important, therefore, to scrutinise carefully those items which, in the ordinary course, are brought forward as balances from one year to another. In so far as their correctness cannot be tested by an examination of the accounts under review, the present auditor is probably not responsible; but in cases where a careful investigation of the current accounts would have disclosed an error in the previous accounts, it would doubtless be held that the discovery ought to have been made, and that failure to make it was the result of negligence. It may be pointed out, as an instance of the kind of points in mind, that the mere existence of a ledger account headed 'reserve fund', with a balance to the credit thereof, should not be taken as conclusive evidence that a corresponding amount of profits available for distribution has been transferred to reserve; while it would be only prudent to remember that the amount of depreciation to be written off all wasting assets in the period under review is conditioned by the question whether correct principles have been observed in this respect in previous years.

An important additional detail is to make a note of the terms of any qualification in the previous auditor's last report. If a reservation was of such a character as to refer only to the transactions of a particular past year, it may, in ordinary circumstances, be ignored; but where it directly affects the statement of an asset or liability or goes to the constitution of the company, the question immediately comes up whether the effect of the matter reported on is of a continuing nature. If so it may lead to a repetition, or further statement, in the auditor's report of subsequent periods.

THE COMMENCEMENT OF THE AUDIT. In every instance it will be necessary for at least some of the postings to be called over; and inasmuch as by that means the auditor will at once acquaint himself with the nature of the transactions that have occurred, the calling back of such postings will form an appropriate commencing point of the examination. Many persons prefer to start with an examination of the vouchers, and, if the vouchers are rich in detail, it will frequently be desirable to take them first; but when—as is often the case—they are mostly bare receipts for so much money, it will usually be best to commence with the postings.

It is well to commence with the postings of the cash book, even when all the postings are to be checked, as by this means a general

idea of the business done is most quickly grasped; which is very desirable. The calling over of postings can hardly be too carefully done, and although the work is decidedly mechanical—and, consequently, somewhat somniferous—it must be most conscientiously performed. In particular, care must be taken not to pass any item already ticked unless it be certain that it has been ticked inadvertently in the regular course of audit; further, any items remaining unticked after the calling over is completed should receive most careful attention. Inexperienced clerks are apt to 'suppose' they ought to have ticked an item, or to 'suppose' they ticked such-a-one instead of such-another. Either 'supposition' may cause a fraud to remain undetected, or (which will perhaps appeal to the youthful mind more powerfully) may keep the junior late at his work night after night, while his senior hunts up and down for an error in the trial balance. When the error is discovered to be a mistake in the posting that was passed in calling back, it is possible that the unfortunate junior will be even more sorry that he ever ventured to 'suppose'.

Where it is intended to check every posting, it is a good plan, after the cash postings have been checked, for the remaining postings to be called back from the ledger into the various journals; and it will probably save time, while going through the ledgers, to check the additions and balances at the same time, and so finish each ledger at a sitting. This method, however, is not always convenient, or even possible, and much must therefore be left to the discretion of the clerk in charge.

BAD OR AMBIGUOUS FIGURES should always receive close attention, as it not infrequently happens that they are posted as one figure and added as another. Corrections, too, require careful attention. Erasures should always be strictly prohibited; and where hand-made paper is used they should be keenly watched for, as in that event a perfectly clean erasure may easily have been made. It is very important that the room used by the auditors be well lit, or mistakes may easily occur. Where a correction has been made, care must be taken to ensure that the addition and posting have both been altered. In a continuous audit this is especially important.

It may seem almost superfluous to say that the clerk calling back should always speak clearly, but experience teaches that this is a matter that frequently does not receive the consideration it deserves. Such a mistake as £20 3s. 9d. being posted as £23 9s. 0d. may be guarded against by emphasising the last syllable of the pounds, thus—'tween-ty, three, nine.' It is important that the clerk calling should learn to 'pull with' the one who is turning over the folios. This is a habit much more readily acquired by some juniors than others—in many respects it resembles the art of accompanying music—and the senior who has found a youngster to suit him will not willingly make a change, as the economy of nervous force consequent upon perfect accord is very considerable.

CHECKING ADDITIONS. In all small cases it is desirable, although it is not always practicable, that all the additions should be checked.

In every case, however, the additions of the private ledger, nominal ledger, cash book, bill books, petty cash book, and wages book will require to be verified. This should always be done when the other work connected with the same book is being done; for, if the book-keeper has power to make alterations meanwhile, he can afford to laugh at every safeguard against fraud.

It is hardly necessary to add that the checking of additions, though purely mechanical, is most important work. It is especially necessary that the 'carried forwards' be checked on to the following page, as errors frequently occur here. Also, when checking the additions of a book with several columns of figures, it is important to see that the distinction between the various columns is observed when carrying forward totals from one page to another.

Where journals or petty cash books are of the columnar type and where one column thereof is reserved for direct individual postings, it is very important that the auditor should not be content with agreement of cross-tots unless the castings of the 'individual' column are also checked. A little consideration will show that a compensating error between this column and one of those posted in total will be concealed by cross-casting but will nevertheless cause a difference in the books.

Experience also shows the necessity of reminding beginners to cultivate the habit, when checking ledger additions, of watching automatically that the two sides of the account are equal and that the balance, if any, has been carried down correctly. It is easy to fall into the error of bringing down a total instead of a balance.

A word must be added about test-checking additions, where the arithmetical balancing of books is not in question by checking the additions of such books as sold journals approximately, i.e. so as to avoid the risk that serious errors only may exist. These additions may be checked to the nearest pound or so by ignoring the pence and the units columns of the shillings and by commencing with the tens column of the shillings. These may be called pounds without risk of serious error unless some influence be at work which might interfere with the even distribution of quantities in the shillings column. The fact that the units figure in the pounds column is likely to average $4\frac{1}{2}$ may be taken advantage of to aid a similar process of wider approximation.

VOUCHING. It is very important that every auditor should realise that the establishment of the correctness of the books, regarded merely as an exercise in double entry book-keeping, is only the beginning of an audit. Indeed, it has often been remarked that the very neatness with which double entry tucks away all loose ends may operate to lull an auditor into a false sense of security unless he be very much on his guard. The process of vouching may be said to apply the necessary corrective. Vouching consists in comparing entries in books of account with documentary evidence in support thereof. A satisfactory voucher should provide independent evidence that the event which the relative entries purport to record did actually take place, and, further, that the entry correctly reflects the effect of the transaction in question. It may be as well to point out at once

that vouching is very different in its technical sense from 'verification'. The latter process consists in establishing whether a state of *existent facts* recorded in the books is truly so recorded or not. The difference between the two processes can be illustrated in a nutshell from the cash book. An auditor vouches the cash book by calling for evidence whether the recorded transaction actually took place in the historical sense; he verifies the balance when he calls for proof that the figure carried down at debit is actually an existing asset of the company.

The matter may most conveniently be dealt with under the following heads:

- (a) Cash book receipts.
- (b) Cash book payments.
- (c) Petty cash.
- (d) Wages.
- (e) Income-tax under the Pay-as-you-earn system.
- (f) National Insurance.
- (g) Bank account.
- (h) Purchase and expenditure journal.
- (i) Sales journal.
- (j) Journal proper.
- (k) Bill books.

Each of these involves, for its consideration, questions as to the form of accounts employed, but the relative merits of the various forms available will be more conveniently dealt with at a later period.

(a) CASH BOOK RECEIPTS. It is part of the auditor's duty to ascertain, as far as possible that all remittances received have been entered to the debit of the cash book. It will be observed that in this matter the ruling principle in the mind of the auditor must be not merely to examine the entries in the cash book itself but to search for evidence of receipts not therein brought to debit. The usual mode of verification available will be a comparison of the counterfoils of the receipt books with the cash book entries. Counterfoils should always be numbered, and the book-keeper should mark the cash book entry with the number of the receipt. It is necessary that the auditor should notice that the numbers of the counterfoils run consecutively, and if there are any numbers missing, or any counterfoils left blank, a satisfactory explanation must be found. If a receipt has been cancelled, the body should remain attached to the counterfoil; for it need hardly be pointed out that this is much more satisfactory than any other explanation possible. The receipt for two accounts paid together should be acknowledge on two separate forms. If there be no hard and fast rule, there is nothing to prevent the collector from using separate counterfoils while using only one receipt, which, of course, leaves him an extra receipt form to use for another acknowledgment which he need not account for. Defalcations have frequently arisen, or remained undetected, from a neglect of this precaution.

On the other hand there are some cases where it may prove better

to *forbid* the use of two receipts for two payments made the same day. This course, however, leaves it open to the collector to account for the two payments on different days, and so gain possession of a blank form. In either case, the special point is that there should be one fixed rule, which should be rigidly maintained. But whatever precautions be taken, the method is by no means infallible, and in consequence many accountants have advocated the issue of a circular to all customers, requesting a verification of their respective accounts as quoted. This method is, of course, quite impracticable in the case of a retail business but among wholesale houses sometimes proves a valuable precaution. As a rule, however, wholesale accounts are run upon certain known terms as to credit, so that any irregularity would be apparent to the observant auditor. In any case, the auditor must not communicate with his client's customers on his own responsibility; and, as a rule, the practice is thought to be undesirable save in cases of grave irregularity, when some special inquiry becomes necessary in order to ascertain the actual position. It need hardly be added that the mere statement by a customer that he has paid his account cannot always be regarded as conclusive.

The dates of the counterfoils should always be compared with the cash book entries. The existence of a time gap would lead to the query whether the cashier is making use of his employer's money for his own purposes.

Manifold carbon receipt books have of late years very largely taken the place of counterfoil books. In spite of the suspicion with which they are regarded in some quarters, it is thought that upon the whole they are more efficient.

It has, unfortunately, become the custom of many large firms to send their own form of receipt with remittances, and the efficacy of counterfoil receipt books is thereby much impaired. So far as possible, the auditor should ascertain what firms do adopt this practice—and here he will, perhaps, find the knowledge gained at one audit may help him to detect something wrong at another.

Dividends and compositions in bankruptcies, &c., will inevitably have been accompanied by a special form of receipt; if, therefore, such entries be found upon a receipt counterfoil, the circumstances may well give rise to suspicion. The counterfoil of the dividend notice in such cases should always be produced as a voucher.

In cases where there are large numbers of receipts mostly of the same nature and amount, as, e.g. club subscriptions, the cash received may usefully be vouched in total by first establishing the composition of the membership register and then inquiring into the difference between the total actual receipts and the sum which should have been received. A list of subscriptions not collected should agree with the figure so ascertained, and that list should be brought to the notice of an independent and responsible official.

Cash sales require very careful scrutiny, and the method of internal check adopted should always be ascertained, and, as far as possible, perfected. The auditor should not imagine that vigilance may be relaxed because such sales are few in number, for it is in these very

cases that speculation is most likely to occur. It is of the utmost importance that this matter should be characterised by regularity of procedure. Generally speaking, as many persons as possible should be brought into connection with each such sale and no person should be placed into such a position that he might profit financially by an error in the record for which he is responsible. For this reason every sale should be recorded by the salesman on a numbered docket and the cash itself should be placed in the custody of a second person, still a third being responsible for the cash book entry. In large stores care must be taken by the management to control the issue of the books of dockets so as to avoid the risk that 'secret' books may be held by salesmen, the dockets being suppressed; in such cases a regular system of analysis and cross analysis of the dockets is essential, combined with a definite means of agreeing the cash records with the record of total sales, these two matters being separated *ab initio*.

Special items of receipt will be more conveniently dealt with when considering the audit of various kinds of accounts.

(b) CASH BOOK PAYMENTS, other than those for wages and petty cash, should (where possible) invariably be made by cheque payable to 'order', and crossed. Even where the amount is only a few shillings this method of payment will, in the majority of cases, be simpler, as well as safer, than cash payments. Receipts can readily be obtained for all ordinary payments, which should be numbered consecutively (the numbers of the cheques are very useful for this purpose), as should also the items in the cash book.

A receipt on the payee's own printed form is very much better evidence that he has received the amount stated, than a receipt on the form of the payer, although, doubtless, a uniform type of voucher will save the auditor's time slightly. From both points of view, it is not desirable that *payers* should provide their own form of receipt; be this as it may, however, the practice exists, and will probably continue.

The endorsement on a paid cheque by the payee thereof is evidence of payment of the amount of the cheque, and to this extent it may be received at audit. But such an endorsement is not a satisfactory discharge of indebtedness because it lacks the stamp duty attracted by receipts; hence the payer would not be able to bring the endorsement into Court as proof of payment in case of dispute. The duty of an auditor who is asked to take such an endorsement as a voucher seems therefore to be to accept it at audit but to draw the attention of the client (preferably in writing) to the fact that a stamped receipt is missing, there being a consequent possibility that a second payment may be successfully demanded.*

In this connection it is remarked that there is a growing practice to issue a form of cheque incorporating a receipt to be given (and stamped if necessary) by the payee. No audit objection can be raised although the practice sacrifices the valuable advantage of having the payee's receipt on the face of a detailed statement of account. Such cheques are not 'unconditional orders' within the statutory definition of a

* See remark of Talbot, J., in *Armitage v. Brewer and Knott*, Appendix B.

bill of exchange and consequently the banks demand an indemnity from their customers who decide to use them.

Some special payments cannot be vouched in the usual way (e.g. insurance premiums on a new policy); but satisfactory evidence that the payment was actually made, and value received, should always be obtained.

(c) PETTY CASH. Whatever system of petty cash be adopted, the vouching of petty cash, as a whole, will be the only possible real verification of the payments made from cash to petty cash, and the matter may be referred to here though consideration of systems of petty cash keeping must be postponed. The actual inspection of petty cash vouchers may, or may not, be undertaken by the auditor, as he thinks fit. In the former case, a responsible person must certify the whole of the items *en bloc*; and in the latter case, a similar person must pass each separate voucher. Important frauds are hardly likely to occur in petty cash; but, as likely as not, petty peculations will arise if an efficient supervision be not exercised. No auditor can properly supervise the petty cashier, and it is well to acknowledge the fact fully; he may, however, see that every payment has been duly authorised by the responsible head, that the payments made by the cashier have been duly acknowledged, that the additions of the petty cash book are correct, and that the balance unspent is in hand. Beyond this in ordinary cases he can hardly attempt to go. It is always preferable that the examination be carried right down to the date of the actual audit.

Some clients have a very bad habit of making comparatively large payments through petty cash. This should be discouraged as far as possible. Some have a still worse habit of allowing the petty cashier to *receive* small amounts; this is a very bad system, and should be most vigorously contested. All receipts should be banked no matter how trifling in amount, and a clerk in charge of cash receipts should never (save in the smallest offices) be in charge of cash payments.

(d) WAGES. Instances of fraud in the payment of wages are among the most frequent of those that come under the notice of an auditor; but, from the very nature of the case, direct evidence of proper payment is all but impossible. The auditor's first line of defence is a good *system* of control, which renders fraud quite improbable by reason of the number of persons concerned in the preparation of the pay-sheet and the subsequent payment. Particulars of time worked or piece-work done should be certified by the foreman or overseer; the calculations of wages worked by one office clerk, and checked by another; the cash for the wages made up by the cashier, and the wages paid by him or his deputy in the presence of a works manager. Where possible, a cheque should always be drawn for the exact net amount of wages required (i.e. after deducting income-tax and the employees' national insurance contributions), but where this is impracticable it is desirable that the excess drawn should be repaid to the bank forthwith. The auditor should inquire as to the particular

system adopted, and should ascertain that it is really carried out; sometimes it might be well for him to put in an unexpected appearance when the wages are being paid. The wages book should always be added, the summarisation should be carefully checked and a week or two's wages should be taken at random and checked in thorough detail. The net total of each week's pay-roll should then be compared with the cash book entry.

Each week's wages roll should be signed (a) by a responsible official who thereby takes responsibility for seeing that the wages recorded are properly *due* to the parties named in respect of work performed for the company's benefit; and (b) by another official who is responsible for supervising the actual *payment* to those parties.

Comment may be made here on the importance assumed, in connection with the audit of wages, by a good system of cost accounts. This will demand the cross analysis of the pay-roll on the basis of its connection with particular jobs or processes and if the results are carefully watched by the management it is obvious that such a system throws an additional difficulty in the way of a fraudulent wages cashier.

Even where the audit of the wages book is a matter of tests only, the auditor should not omit to *scrutinise* every pay-roll with a view to forming an opinion whether any suspicion should be aroused by particular entries. Thus, the sum placed against every name should be reasonable in amount and no amounts should appear (without thorough explanation) against such vague headings as 'cartage' or 'labourers'.

(e) INCOME TAX UNDER THE PAY-AS-YOU-EARN SYSTEM. The statutory authority for the system known as 'Pay-as-you-earn', by which employers are required to deduct income-tax from wages, salaries and other emoluments, is contained in the Income Tax (Employments) Act, 1943, and the Income Tax (Offices and Employments) Act, 1944. A code number for each employee is determined by the Inspector of Taxes, having regard to the circumstances of each individual and the reliefs and allowances from income-tax to which he or she is entitled. The employer is supplied with tax tables from which can be calculated the amount of income-tax to be deducted from each payment of wages or salary; the amount of the deduction depends upon the code number of the employee and upon the amount of the wages or salary. If the code number has been correctly determined and the deductions have been correctly calculated, the total amount of income-tax deducted during the income-tax year will be approximately equal to the income-tax which the employee ought to bear under the general income-tax law. Excessive or inadequate deductions will usually be adjusted by decreasing or increasing, as the case may be, the deductions in a subsequent period. The tax tables are constructed in such a way that at any point during the income-tax year the aggregate or cumulative deductions for each employee from the commencement of such year will approximately correspond to the amount of tax that would be appropriate to the cumulative wages or salary from the commencement of the tax year to the date in question, after giving the employee the

benefit of such a proportion of his reliefs and allowances as corresponds to the proportion of the income-tax year which has elapsed. Should an employee suffer a loss or reduction of wages through absence from work or any other cause, or should his circumstances change in such a way as to reduce his liability to income-tax, it will be found that the employee's cumulative income-tax is less than it was at the previous pay-day; in such a case, the employer must refund to the employee the amount of the difference.

The income-tax year is divided, for purposes of collection, into twelve monthly periods commencing on 6th April. Within fourteen days of the end of each income-tax month, the employer must remit to the Collector of Taxes the total amount which he has deducted from wages and salaries during that month, less any refunds of tax which have been paid by him to any employees. If, in exceptional circumstances, the refunds should exceed the deductions, the employer may set off the excess against the amount due to the Revenue for the following month, or he may claim reimbursement from the Inland Revenue authorities. The employer is supplied by the Inspector of Taxes with a tax deduction card for each employee, on which he must record, week by week or month by month, as the case may be, the cumulative wages or salary, the cumulative tax, and the tax deducted or refunded for each week or month.

On the termination of an employment, the employer must prepare a certificate (Form P45) in which is shown the employee's code number, cumulative wages or salary from the commencement of the income-tax year to the termination of the employment, and the total tax deducted for the period. This certificate is in three parts, one of which must be sent by the employer to the district tax office. The two remaining parts must be handed to the employee, who must present them to his new employer; the latter must prepare a tax deduction card, and enter thereon the particulars contained in the certificate. Deductions of tax will then proceed in the same way as if the wages paid and tax deducted by the former employer had been paid and deducted by the present employer. A special system of deduction applies in the case of employees for whom no tax deduction card is received from the Inspector of Taxes and in the case of a new employee who fails to produce the certificate from his former employer. The method of deduction in these cases is set out on a document known as the emergency card.

The auditor must satisfy himself that tax deductions and refunds have been correctly made, and that the correct amount has been remitted to the Collector of Taxes. He should therefore examine the tax deduction cards, and check a proportion of the calculations; the cards selected for this test check should be compared with the wages book. The amount of tax deducted in respect of each employee should be shown in a separate column in the wages book, and the entries in this column should be compared with the deductions recorded on the tax deduction cards.

In the case of salaried employees, directors and others, the emoluments will not, of course, be recorded in the wages book, and in these cases the tax deduction cards must be compared with the salaries

book or list, and with any other evidence of payment. The amounts paid to the Collector of Taxes should be confirmed by a scrutiny of the official receipts issued by the Collector.

Failure to deduct the correct amount of tax from wages and salaries does not relieve the employer from the obligation to pay the correct amount to the Collector of Taxes. It is true that the Commissioners of Inland Revenue, if they are satisfied that reasonable care has been taken and that the under-deduction was due to an error made in good faith, may direct that the amount in question shall be recovered by the Collector of Taxes from the employee. Nevertheless, if anything less than the correct amount has been deducted, there is at least a risk that the employer may be required to pay the amount of the deficit to the Collector.

The fifth day of each calendar month is the end of an income-tax month, and, as mentioned above, the employer is allowed a period of fourteen days within which he must remit to the Collector the net amount deducted during the income-tax month. Since the financial year of the business will usually end on the last day of a calendar month it will be necessary to ascertain the amount of tax deducted during the closing weeks of the financial year which has not, by the end of that year, been remitted to the Collector of Taxes. The tax deducted should be debited to wages and salaries accounts and credited to an account in the name of the Commissioners of Inland Revenue or headed 'P.A.Y.E.' The latter account will be debited with the amounts remitted to the Collector of Taxes. Any amounts deducted but not remitted will thus appear as a credit balance on the P.A.Y.E. (or Commissioners of Inland Revenue) account. In exceptional cases, if refunds exceed deductions, wages account may be credited with the excess, and P.A.Y.E. account debited.

(f) NATIONAL INSURANCE. All employees above 15 years of age are included within the comprehensive national insurance scheme which was introduced by the National Insurance Act, 1946, replacing an earlier and more limited scheme of State insurance. The cost of the weekly stamp is divided between the employer and the worker. The liability to affix the stamp falls primarily on the employer who recovers the workers' proportion by deduction from the gross wages. This matter has introduced a special element into the audit of wages books, because it is necessary to introduce therein columns for the employer's and workers' portions of the stamps to be affixed weekly. It is clear that the total amount of cash to be paid out weekly is the net amount payable to the workers plus the total amount of the stamps on the insurance cards, or, putting the same thing another way, the gross amount of the workers' wages less income-tax deductions plus the portion of the stamps to be borne by the employer. Many frauds have occurred through money being drawn by cashiers for insurance stamps which have not actually been affixed to the workers' cards. It cannot be expected, of course, that the auditor should follow the history of every contribution, but it is submitted that a salutary check is attained if on the actual date when the audit is performed the auditor calls for

the insurance cards of at least a section of the previous week's pay-roll in order to ascertain if those cards are *prima facie* in order. With regard to the book-keeping portion of the matter, although the cash is actually disbursed as to the insurance stamps to the post office and as to the net wages to the workers, nevertheless it is more convenient in the books to carry the gross wages to wages account and the employer's portion of the stamps to national insurance account. The cash book entry should be phrased accordingly.

(g) **BANK ACCOUNT.** All payments into the bank should be checked off against the pass book or its equivalent. The composition of a few such payments (as shown by the counterfoil paying-in book) may be advantageously compared with the items which they purport to represent, and any irregularity carefully followed up. It is sometimes possible in this way to discover the abstraction of cash, its place being taken in the books by cheques received from debtors. The step now recommended is particularly desirable at the end of a financial period where deposits are recorded, but these are not credited by the bank till the new period. The credit side of the cash book should also be checked off against the pass book, and any disagreement of the *names* should receive careful attention. The approved method of effecting this comparison is to use the paid cheques themselves as the link between cash book and pass book. The cheques should be arranged in numerical order and should be compared *seriatim* with the cash book entries. The cheques can then be compared with the pass book by reference to the date of payment which is either stamped or perforated by the bank on the cheques themselves. Where it is not feasible to treat the whole cash book in this way a double test should be performed, i.e. a section of the cash book should be followed to the pass book with the cheques as a link and then another section of the pass book should be traced back to the cash book. The question of the verification of the balance at the bank and its agreement with the balance of the cash book is dealt with later.

It need hardly be said that the only really satisfactory cash system provides for the banking of all receipts intact. In cases where this rule is not followed there will possibly be a balance of cash in hand at the end of the period. If this balance has not actually been paid into the bank it will be necessary to audit the cash book right down to the actual date of audit and to verify the balance of cash then found to be in hand.

(h) **PURCHASE AND EXPENDITURE JOURNAL.** The vouching of this book or its equivalent is one of the most important operations in the whole field of an audit. The reason for this importance lies in the fact that the invoice submitted by a creditor is a true originating document since it initiates a transaction which results later in a payment. The receipt subsequently given may be evidence of payment being made, but it is the invoice which enables the auditor to authenticate the expenditure and to check its distribution to the proper nominal or capital headings. It is most important that the invoices

should be scrutinised with a view to seeing whether they have been systematically dealt with by the client's staff. Such a system must include their comparison with the order and with the storekeeper's report of the receipt of the goods. The invoices must also be arithmetically checked and the accountant must indicate the account which is to be charged. These matters are usually dealt with by initials over a rubber stamping. It is for the auditor to compare the names and amounts (before cash discount is deducted) with the entries in the journal, and it is suggested that the opportunity should be taken to verify the correctness of the analysis if the journal is kept on the columnar principle, as is usual. It is a convenient plan to place the vouching mark against the item so extended into the analysis column. The attention of the audit clerk is thereby drawn to the importance of watching the analysis as well as the other particulars of every item. Statements, as distinct from invoices, should be rejected, and no item which does not bear the ordinary routine stamp should be accepted.

Particular attention should be paid to the invoices at the beginning of a financial period with a view to ascertaining whether the items relate to a past period; similarly, special attention should be given to the purchase journal at the close of a period with a view to noting indications that items of purchases or expense have been suppressed. If there is any suspicion of malpractice such as this the auditor should make a diligent comparison of such initial records as storekeeper's books, duplicates of orders, &c.

Items charged to capital should receive special attention and audit clerks should be encouraged to draw their principal's attention to items so charged which do not appear to them to fall clearly within the capital category.

If a system of mechanised accounting is in use, the invoices are posted direct to the ledger without passing through a journal. In these circumstances, the invoice must be vouched with the entry in the ledger.

(i) **SALES JOURNAL.** It is not usually thought necessary to pay such close attention to this record as to the record of purchases. The auditor's chief objects are to see on the one hand, as far as possible, that all goods actually sold have been recorded and, on the other hand, that all the recorded sales are proper items for credit in the trading account. In the majority of modern cases it is customary to preserve carbon copies of the actual selling invoices, and it is a good plan to have these numbered serially by the printer. In such a case an effort should be made to establish by test that all the serial numbers are present. The client or his officials should be questioned on the point whether any non-trading items have been passed through and, if there are any such, they should be carefully scrutinised with a view to excluding them from the trading account.

Purchase tax must be stated separately on the sales invoice and should be shown in a separate column in the sales journal, from which it will be posted to the credit of purchase tax account in the ledger.

Particular care must be exercised with regard to the sales at the

end of a period and, if there are any signs of inflation, inquiries should be made. Great care is necessary in cases where there are subsidiary or allied companies. Instances of fraud have frequently occurred in this connection, sales account being bolstered up by putting through transactions which are either wholly fictitious or which are valued at figures which would not be supported in the commercial market. It is necessary that the auditor should be convinced that in such matters as this his client is observing good faith towards him and if there is any evidence to the contrary his duty to probe the matter to the bottom is quite clear.

Where mechanical methods of posting are employed, it is usual to dispense with the sales journal, and the sales invoices are posted direct to the ledger.

(j) JOURNAL PROPER. The modern journal being the book of first entry in which comparatively unusual transactions are recorded, it becomes just as important that the journal entries should be fully vouched as it is that those relating to cash receipts and payments should be subjected to the same scrutiny. If the correctness of all entries passed through the journal be taken for granted, there is no limit to the amount of falsification that might be committed with impunity. Improper journal entries might be made with either or both of two objects, namely (1) to conceal defalcations, as, for instance, when customers are improperly credited with the amount embezzled, and a corresponding debit made to allowance for bad debts; (2) to exaggerate the profits of the undertaking—e.g. by crediting nominal accounts and debiting real accounts with items that cannot properly be capitalised. It is impossible to deal in detail with the vouching of journal entries, on account of the very various nature of the transactions that might be recorded in this book; it may be stated, however, that where in the nature of the case documents are not available, only the evidence of some disinterested party—or, that being unobtainable, the evidence of some person absolutely above suspicion—should be accepted as a voucher, and in the case of all important entries the auditor should take steps which will enable him to form a definite opinion of *his own* with regard to the matter.

(k) BILL BOOKS. Bills payable will present but little difficulty the returned draft is, of course, the voucher for the payment of bills matured, while the bills running (as shown by the bills payable book) will explain the balance of the bills payable account in the ledger. It is obvious that none of these current bills should have reached its maturity date at the end of the financial period.

Bills receivable book requires more careful consideration. The items therein, where representing bills matured or discounted, should be traced into the cash book. If any of these bills should have been dishonoured, or renewed, they must be traced back to the debit of the customer. All bills dishonoured, or still running and undiscounted, should be in hand and should be produced for inspection.

Care should be taken to see that the discount deducted when bills

are discounted has been dealt with properly in the books. The important question of the liability upon bills under discount, and the value of bills dishonoured, is mentioned here although later reference will be made to the points. It may be added that dishonoured bills should never be allowed to remain on the bills receivable account of the ledger, but should be carried to the account of the customer there to be dealt with as circumstances dictate.

GENERALLY. A practical consideration in connection with vouching is with regard to the actual marks an auditor should make to indicate that this work has been performed. In the first place, the voucher should be so marked that it cannot afterwards be used in support of another entry; and, in the second place, the entry that has been vouched should be so marked that the auditor can afterwards readily ascertain what items remain unvouched. With regard to the marking of the vouchers, the almost universal modern practice is to use a rubber stamp bearing the name of the firm either with or without the clerk's initials.

The main object is so to disfigure the voucher that it cannot again be used in support of another entry. Where a rubber stamp is not employed the initials of the responsible clerk should be placed clearly across the face of the voucher, but this method is neither so efficacious nor so quick. With regard to the marking of the entries in the books as being vouched, some firms employ a distinct 'V', which has the advantage of being clearly distinguished among various classes of ticks, and so enabling a list of missing vouchers to be more readily compiled. Sometimes, however, an imperfect voucher is accepted, and in such case it seems desirable that a special form of mark should be employed, so as to guard against the real voucher being produced in support of another entry. It is suggested that the marks may advantageously be made on the *right* of the figure vouched, so as to distinguish them clearly from posting ticks.

Where the auditor suspects irregularities that he is unable actually to detect, he may frequently gain his point by *feigning laxity* in his method of vouching; this will often serve to induce that carelessness on the part of the defaulter that is necessary for his detection and exposure. It is, however, obviously necessary, on many grounds, that the method be practised with discretion.

THE TRIAL BALANCE. It should be the auditor's aim, so far as possible, to carry each part of his investigation right up to the trial balance at the same sitting. In an important audit, this can very rarely be accomplished; but the auditor must always remember that there is danger in leaving any portion unfinished in the hands of book-keepers or cashiers, who—for all he can know to the contrary—may manipulate the figures during the course of the audit. He should, therefore, endeavour to complete everything as he goes along, and where he is unable to finish the same day, he will do well to keep possession of the books and documents until he can. In fact, he should, as far as possible, keep everything in his own hands until the audit is

completed as far as the trial balance. Having once secured a trial balance that he knows has not been tampered with, the auditor may cease to trouble himself about the materials from which it was built up—they may be manipulated and altered up and down, but he holds in his own hand the key to the whole position.

BALANCING. In the foregoing paragraph it has been assumed that an exact balance has been arrived at by the book-keepers before the auditor commences his investigation. This, of course, is as it should be, for clearly it is no part of the auditor's duties (as such) to balance the books. The question arises, however, whether an auditor is ever justified in passing accounts that do not exactly balance. Obviously, accounts that do not balance cannot be entirely accurate; but if the auditor is satisfied that in all probability the discrepancy arises from one error, and not from the combined effect of numerous errors, and if the difference is so small as to have no practical effect upon the ultimate result, the absence of an accurate balance may sometimes be disregarded. Here, as elsewhere, however, much depends upon circumstances; a nominal or private ledger—or indeed, any ledger with less than, say, 500 accounts—ought certainly to balance exactly; on the other hand, where old-fashioned hand-posting methods are in vogue, it is hardly practicable to ensure an absolute balance of a large trade ledger—hence the importance of these balances being tested at frequent intervals, say, monthly at least.

METHODS OF BALANCING. In private audits it not infrequently happens that the auditor is requested to balance the books. The detection of errors in balancing is thus a matter with which an auditor occasionally has to deal, although it does not in any sense form part of the actual audit itself.

It must be said that the introduction of mechanical means of ledger posting has removed most of the excuses which at one time might be urged for the existence of balancing errors. It is safe to say that the continued occurrence of these errors is, to-day, a clear signal that the office in which they occur needs prompt overhaul. Should it be necessary to trace an error, the auditor's experience will enable him to decide whether the quickest course is to call back all the postings and check all the additions, or to resort to a more specialised method. The skilled accountant can often, by careful consideration of the exact difference, point to the most likely source or sources of the error.

It may be well here to refer again to what was said, when additions were being discussed, about the importance of guarding against the occurrence of compensating errors in columnar books of original entry, as between columns posted in total and those posted individually. Further, it is perhaps not out of place to remind auditors that errors of transposition between money units can sometimes be discovered by treating the difference as follows: add to the pence sufficient to make them one shilling, then, carrying the one, add to the shillings enough to increase them to the quantity added to the pence.

	£	s	d
Thus, if the difference is (say)	3	3	5
Add		3	7
	<hr/>		
The difference arises because 3s. 7d. is posted as	3	7	0
	<hr/>		

The two specialised methods of seeking for errors referred to above are:

1. Localisation.
2. Tabulation of the ledger.

LOCALISING THE ERROR. This is, of course, best accomplished by framing the system of accounts upon such lines that each separate ledger is 'self-balancing'. Where this has been done, it is a very simple matter to see in which ledger or ledgers the discrepancy arises, and the field is at once narrowed accordingly. It may easily happen, however, that the various ledgers have not been framed upon self-balancing principles; even then it does not necessarily follow that the error cannot be localised. If the cash book be in tabular form, or if there be separate subsidiary cash books, the equivalent of an adjustment account can almost always be constructed; transfers from one ledger to another may complicate matters, but unless such transfers are much more numerous than is usual, they will not present serious difficulty. On the other hand, it is not often practicable to apply this method if it necessitates extensive analysis of the subsidiary books.

When the books of first entry have not been in the first instance so formulated as to lend themselves readily to the construction of self-balancing ledgers, a method of check described by the late Sir J. G. Craggs, M.V.O., F.C.A., in his *Heavy Trial Balances made Easy*, will sometimes be found useful. A complete description of this system would be impracticable here; but it may be mentioned shortly that the system consists in requiring the clerk calling back from the book of first entry to the ledger to compile, *as he calls back the various entries*, a list of the amounts posted into each separate ledger. By this means the total amount posted into each separate ledger, and the sources from which it is posted, may be readily ascertained. The system also provides a convenient means of quickly discovering any clerical errors that may have been made in the compilation of the abstracts. Where a large set of books has to be balanced for a comparatively long period this system will be found most useful, the more so because—so far from adding to the time required for calling back the postings—it utilises the time of the junior which would otherwise be wasted, and thus directly tends towards both accurate and expeditious work. It may be added that this plan lends itself to the use of adding machines of the 'listing' type whereby speed, accuracy and legibility may be attained in marked degree.

TABULATING THE LEDGERS. This is a method which is sometimes adopted where the number of ledger accounts is not large, and,

where practicable, it is extremely thorough. It consists of making an abstract of every ledger account upon sheets, which are virtually tabular ledgers. When the abstract has been completed, the checking of the cross-additions proves the extraction of the ledger balances, while a comparison of the longitudinal totals with the opening balances, sold journals totals, total of cash received, &c., will show in which direction the error lies. Thus, if the total 'goods sold' does not agree with the total 'sales account' in the nominal ledger, there is clearly an error in the postings or the additions of the sold journals. Many accountants, however, and among them the author, prefer to re-check the ledger carefully, item by item, rather than adopt such a laborious process of localising the error—especially when it is remembered that even when the abstraction of the ledger has been completed, the localisation has been directed, not to one ledger account, but to one subsidiary book.

From the author's point of view, the chief value of the tabulation of the ledgers arises in connection with the conversion of books previously kept by single entry into double entry; this is a feat which is sometimes necessary when examining the books of an undertaking about to be converted into a limited company, or when endeavouring to frame a deficiency account in cases of insolvency.

CHECK FIGURES. The employment of 'check figures' as a means of testing the clerical accuracy of postings is still advocated in some quarters, but it is thought that the various systems suffer from the positive disadvantage of concentrating the book-keeper's attention on mathematical processes at the very moment when accuracy of accounting (with all that that implies) is essential. Moreover, the introduction of mechanical aids to posting has provided book-keepers with an engine of efficiency against which no mental process can compete.

SHORTCOMINGS OF THE TRIAL BALANCE. It is well to conclude this chapter on a note of caution. It is necessary again to emphasise how dangerous it is for an auditor to get into the habit of regarding double entry as the be-all and end-all of accounting. The agreement of a trial balance certainly proves that the processes of which it is a result have been accurately performed in the technical sense; but it as certainly does not prove that all the entries are correct from the auditing point of view, nor does it prove that the books are a complete record of all the transactions. The shortcomings of the trial balance, from the auditor's point of view, must accordingly be borne prominently in mind and for the sake of completeness they are listed below:

1. Transactions may be omitted altogether.
2. Transactions may be recorded at wrong values from the very commencement.
3. Fictitious or duplicated transactions may be entered.
4. Items may be posted to the correct side of wrong accounts.

5. The last named error may be of such a nature as to constitute a fundamental error of principle, as where a capital item is treated as revenue, or the reverse.
6. Compensating errors may occur, thus leading to an agreement arrived at by mere accident.
7. Adjustments, e.g. for incomplete transactions, such as depreciation and accruing expenses, may not have been made.

CHAPTER III

METHODS OF ACCOUNT (Suggested in the Course of Audit)

It is not strictly any part of the auditor's duty to offer suggestions or issue instructions as to the system of accounts to be adopted, but on account of his experience in such matters he is frequently asked to do so. The following remarks will, therefore, not be amiss in the present connection; but it will, of course, be understood that the various questions now about to be considered are, for the most part, largely matters of individual opinion. The views stated in the following paragraphs are but those of the author, and it is not suggested that they should be accepted unquestioningly by the readers of this book. Circumstances notoriously alter cases, and in no sphere is this more true than in the realm of accounts.

GENERAL SYSTEM OF INTERNAL CHECK. Internal check may be defined as such an arrangement of book-keeping routine that errors and fraud are likely to be prevented or discovered by the very operation of the book-keeping itself. It is something inherent in the system and differs from internal audit because the latter is applied (by the company's own servants) after entries are completed, whereas internal check operates at the moment when they are made.

This is a matter that may very profitably engage the careful attention of the auditor, for not only will a proper system of internal check frequently obviate the necessity for a detailed audit, but it further possesses the important advantage of causing any irregularities to be corrected *at once*, instead of continuing until the next visit of the auditor, which—even in the case of a 'continuous' audit—is clearly a consideration. It is very probable that the auditor will be asked to make any suggestions that may occur to him for the improvement of the existing system of accounts, or in the case of a new undertaking he may be invited to prepare a system for the use of his clients.

In devising any system of internal check, there are three matters to be specially borne in mind; first the person in charge of the cash should never be permitted to make entries in any ledger, or, at least, in any trade ledger; secondly, each separate ledger should be made self-balancing, or should be so arranged that it can be balanced separately; thirdly, where the trade ledgers are numerous and are not checked in detail by the auditor, the clerks in charge should be changed about frequently, so that if there be any irregularity it may be impossible for it to remain long undetected without implicating the whole staff. When a system of accounts is arranged upon these lines, a detailed audit is frequently not necessary in its entirety; but it is always desirable that the auditor should satisfy himself that the system has actually been carried out as originally designed, and sections of the work should be fully checked at unexpected times.

INSTRUCTIONS AS TO GENERAL SYSTEM OF ACCOUNTS. It is usually desirable that the head book-keeper should be placed in possession of written instructions containing an outline of the system to be followed. These written instructions will naturally vary considerably according to circumstances, and it is impossible to give here more than the barest outline of what may be required. The following points should usually be included:

(1) All cash received to be paid into bank daily. The cashier to have no control over any of the ledgers.

(2) All payments other than petty cash payments to be made by cheque, whatever the amount.

(3) The petty cash book to be kept upon the imprest system under the supervision of the cashier. The clerk in charge of the petty cash must on no account be allowed to receive any moneys for sundry cash receipts.

(4) Proper counterfoil or duplicate receipt books to be used for all moneys received, and vouchers obtained for every payment.

(5) All cash and bank balances to be verified weekly, or oftener, and the facts recorded in a special balance book.

(6) All ledgers to be rendered self-balancing, and all trade ledgers to be balanced monthly. A maximum difference of (say) 1s. to be allowed in any one trade ledger, subject to the approval of the head book-keeper. Where machine book-keeping is practised no differences should be passed.

(7) An adequate system of stock accounts and cost accounts to be provided.

(8) All invoices for purchases to be passed by the goods received department, by the buyer of the department concerned, and by the accountant before being entered in the purchases book.

(9) Statements for trade payments to be passed by some responsible person, preferably one of the partners, or—in the case of a company—the managing director.

(10) The calculations of all sales invoices to be checked before they are entered in the books.

(11) A definite system to be set up for dealing with the collection of overdue book debts.

(12) A thoroughly efficient system of computing and paying wages to be introduced and closely adhered to.

(13) As far as may be possible the duties of every member of the staff should be varied from time to time.

(14) Every member of the staff should be required to take a holiday at least once a year.

(15) No member of the staff should be allowed to perform what are (for the time being) the duties of another.

(16) Every employee having the control or collection of cash to be required to take out a fidelity guarantee insurance policy (usually at the expense of the employer).

In the case of a company:

(17) The minute books to be fully entered up, and kept indexed to date.

(18) All exceptional transactions to be reported to the board at the next meeting for approval or further instructions.

(19) The various books required by the Companies Act to be kept written up, and the necessary returns to be made to the Registrar from time to time.

COST ACCOUNTS. Every system of accounting worthy of the name, that purports to record the transaction of a manufacturer, will provide some method of ascertaining the cost of the articles produced, while many systems recording transactions of a purely trading nature (i.e. buying and selling *only*) will provide means of attaining similar ends by the systematic record of quantities as well as values. In ordinary cases, it is not part of the auditor's duty to establish the correctness of cost accounts. Speaking quite generally, however, it is not difficult for the skilled auditor to form an opinion whether they are scientifically based and therefore reliable. If he can be so assured, the existence of the cost accounts assumes importance for two reasons which outweigh all others. First, the construction of the cost accounts involves a cross-analysis of the expenditures (i.e. under 'unit of production' as distinct from 'nominal' headings), and so tends to bring to light any errors existing in the original material or the analysis thereof. Second, it is only in the light of cost accounts that a reliable valuation of manufactured stock, or work in progress, can be arrived at for purposes of the balance sheet.

✓ **BOOKS OF ORIGINAL ENTRY.** The test of good draughtsmanship in the matter of a scheme of accounting is often to be found in the design of the books of original entry. These and the forms which feed them should be so planned as to serve the needs of the particular business and to bring out the matters which will be essential in the final accounts. It is very important not to overlook the imperative necessity, in most cases, of providing for the sectional balancing of the ledgers.

At the present day the use of the typewriter, with its facilities for multiplying carbon copies, especially when combined with the services of 'listing' adding machines, has largely done away with bound books of first entry. The originating documents are made the media for ledger posting and their totals pass ultimately into the general ledger. The matter is mentioned here because a word of caution is needed. Not only should the forms be carefully drafted so as to be convenient and efficient in use, but an effective system of numbering should be enforced so as to guard against the possibility of loose forms going astray or being illegitimately used.

Speaking quite generally, any departure from a permanent form of cash records should be undertaken only in exceptional cases.

✓ **PETTY CASH.** The author is acquainted with two good systems of petty cash, and with numerous bad ones. It is not proposed to deal exhaustively with the latter, but a good system is sufficiently uncommon to merit a record in these columns.

The system of debiting petty cash payments *en bloc* to profit and loss is bad; and it is therefore assumed that, under each of the following methods, the various payments are periodically analysed. Petty cash should be balanced at least once a month, but frequently it will be found advantageous to balance at shorter intervals. The analysis may be made either by means of analysis columns in the book itself, or by a summary written in the book after being prepared on loose dissecting sheets, as may be found most convenient.

Under the imprest system the petty cashier is started with an amount, say £20, which is estimated to be sufficient for the payments for the month (or whatever other period be adopted). At the end of the month he hands the cashier a summary of his payments, and receives a cheque for that exact amount against surrender of vouchers. On the counterfoil of the cheque, the summary (or a reference to it) is written, and the cheque is written up in detail in the cash book, and thence posted direct to the debit of the various ledger accounts. Under this system no ledger account is required for petty cash, other than an account for the standing imprest. The chief cashier should thoroughly examine the petty cash book each time he draws a cheque and should feel himself free to test the actual existence of the balance of the imprest. The auditor also will, of course, require to see this balance, or to have it properly accounted for.

The other system is more suitable where the expenditure is too large for it to be deemed desirable to trust the petty cashier with an amount sufficient to cover a month's expenses.

In this case, there will be a small initial advance to the petty cashier, and when it becomes nearly exhausted a cheque will be given for the exact amount spent up to date. This system is thus similar to the former, but with shorter rests; but to avoid numerous entries in the cash book the cheques drawn (including that for the initial balance) are posted to the debit of a petty cash account in the ledger. The result of the monthly summary is credited to petty cash account, and debited to the various nominal accounts, either by being posted direct from the summary, or by means of a journal entry. The balance of the petty cash account at the end of each month will thus always represent the amount of the initial advance.

The advantages of the imprest system, under either of its varieties, are very marked. It is the only system which definitely prevents 'running on' with all its attendant evils. The area of any possible irregularity is thus limited to the amount of the imprest. If faithfully worked by the superior officers of the petty cashier it enforces the taking of an account between the parties, for if no account of expenditure be produced, then no cash can be obtained; hence there is little danger that it may be found too late that the records are non-existent or confused and useless. But the greatest recommendation of the system is the ease with which at any moment the correctness of the balance held can be tested, for the petty cashier must be able to produce on demand cash and vouchers to the aggregate amount of his imprest. This last statement explains why it is important that when reimbursing cheques are issued the chief cashier should see that vouchers for the

expenditure are surrendered; neglect of this precaution may result in out of date vouchers being used to support a fictitious cash balance. It must finally be added that the accountant as well as the auditor can profit from the imprest system, for it enables the various nominal accounts to be kept constantly posted as cheques are issued.

In some trades the nature of the operations is such that there is a real necessity to have comparatively large sums of cash readily available. It is often arranged in such cases that the cashier shall have a banking account in the name of the company to be operated on by his signature alone. It is, of course, a simple matter to operate this account on the imprest system. Two precautions are, however, called for. First, the bank should be definitely instructed not to allow an overdraft (for in such a case the cashier might obtain the use of a greater fund than his ostensible imprest) and second, the bank should be instructed, on the other hand, not to allow the balance to exceed the stipulated imprest. This second precaution is some safeguard against the accumulation by the cashier of sums obtained by inflating his monthly demands for reimbursement. All cheques drawn to feed this account should, needless to say, be crossed, or, better still, the matter should be arranged by bank transfer. Where petty cash is an affair of magnitude, such as is contemplated in this paragraph, it is quite usual for the directors to arrange with the auditor (for a special fee) to make a monthly examination and report. Where the cashier's integrity is covered by a guarantee policy (as is very desirable) the insurance company often demands such an audit as one of the conditions of the policy.

RENTS (RECEIVED AND PAID). Where a considerable portion of the income is derived from the receipt of rents, it is probable that some reasonable system of accounts will be found in connection with them; but where the matter is, so to speak, a side-issue, it is quite likely that there will be no system whatever. Cottages let to workmen are, perhaps, the most ordinary instance of a revenue being incidentally derived from rents received. The usual book-keeping method is to deduct the amount of rent from each man's pay, and credit the total deductions to a rent received account. This method might answer if the proper deductions were invariably made; but under such a system--if a man were allowed to get into arrear, or if no wages were due to him--the matter is very liable to be lost sight of; and, in any case, no proper record will be kept of any allowances made to tenants for taxes, repairs, &c. In every case, therefore, a proper rent-roll should be kept. In general, this will be found an actual saving of time in the end; and, in any case, it will probably save its cost by preventing losses in collection.

The proportion of rent accruing, but not yet payable, should be included in the balance sheet as an asset; as also should all arrears, unless, indeed, there is reason to believe that they will not be recovered. All accruing and outstanding liabilities for outgoings must also be included, and the auditor must not be put off with any suggestion that 'they about balance one another'. What he has to deal with are the facts.

In the case of cottage property, occupied by workmen, it is desirable to show the whole matter in a nutshell in the profit and loss account; therefore show rents, less outgoings, on the credit side, and carry out only the net revenue derived.

Where only a portion of certain premises is occupied and the remainder sublet, a similar course should be pursued. That is to say, the total rent paid should be shown on the debit side, the rent receivable deducted, and the net rent paid carried out. It is considered in some quarters that a statement of the net amount is sufficient; but the effect of the sublet premises becoming vacant should be considered, for if this be neglected, the amount stated in the accounts would be liable to sudden and unexpected fluctuations. If accounts are intended to show the whole facts of the case, statements containing the net amount only must be defective.

SELF-BALANCING LEDGERS. All accountants will be familiar with the method usually adopted for verifying the accuracy of each ledger in a system of accounts. It would probably be the exception to find a set of books in which some device for the separate balancing of each ledger is not in use; on the other hand, the instances in which some properly *organised* system of applying this check has been adopted are probably more exceptional.

A common method is to take the total of the list of ledger balances at the previous time of balancing, allow for the total amounts that should have been posted to the debit and credit of the ledger respectively, and the resultant figure should agree with the total of the present list of balances. This method is often of the greatest possible assistance when dealing with books that have been more or less incompletely kept; but it can hardly be called scientific, and is, at best, but a convenient makeshift; nor can ledgers so kept be properly styled 'self-balancing'.

[Every ledger should be so arranged as to possess within itself all the materials of a trial balance. That is to say, the general ledger should contain an adjustment account for each of the personal ledgers, built up from a suitably devised analysis of each of the books of original entry. Book-keeping theory demands corresponding (but reversed) 'general ledger adjustment accounts' in each personal ledger; but in practice these seem to be mere duplications and, in fact, to militate against effective control; they are, in consequence, usually omitted. The adjustment account is a most valuable device, as by this means each ledger can, at any time, be balanced with the minimum of trouble, and absolutely irrespective of the other ledgers. Moreover, in the event of any ledger not agreeing, the side (whether debit or credit) upon which the difference occurs can often, with a little manipulation, be readily perceived. Again, the clerk keeping the general ledger (naturally the clerk most to be trusted, if not actually one of the principles, or, perhaps, even the auditors themselves) has a very good check on every other ledger clerk. It must, however, never be lost sight of that the only reliable verification of the balances of the various adjustment accounts in the general ledger lies in the

thorough verification of the various personal ledger balances. If this fact be lost sight of, there is a serious risk of fraud; but, if the system be intelligently applied, it is a distinct preventive of any kind of irregularity.

The auditor who once adopts this system will find that it not only lessens his own work and that of the book-keeper, but also adds to the completeness of whatever system may previously have been in use; and, further, that it materially increases the satisfaction attendant upon the investigation. Where the auditor himself keeps the private ledger (a not uncommon practice where private persons and firms are concerned) the advantage of making each ledger 'self-balancing' must be sufficiently obvious to need no further demonstration.

TABULAR LEDGERS. Another form of self-balancing ledger—to which indeed the term 'self-balancing' may, perhaps, be more appropriately applied than to the kind described in the preceding paragraph—is the tabular ledger. This ledger is suitable to those concerns in which accounts are rendered only at certain definite intervals, and where the number of customers is extremely numerous while the number of transactions with each customer is but small. These limitations naturally reduce the general utility of tabular ledgers, but they are common in the case of such public utilities as gas and electricity undertakings (now in public ownership) and water companies, and also for the purpose of recording the collection of rates made by various local authorities. In each of these cases the account rendered to the customer usually consists of a single item, and it is therefore possible to arrange for each personal account to occupy a line in a large ledger, the various classes of debits and credits being placed in columns. The great advantage of the plan is that recopying of entries, with its attendant liability to error, is avoided and every entry is at once a debit (considered vertically) and a credit (considered horizontally) or vice versa. The totals of the columns can be agreed with the amounts carried to the various general ledger accounts.

Yet another form of tabular ledger is that in use at hotels. The especial object of this form is to make the ledger do duty not only as a personal ledger showing the state of account between the hotel and the various visitors, but also as a nominal ledger showing the analysed receipts from day to day. In this case the personal accounts occupy columns (an opening in the book being allocated to each day's business) while the nominal accounts result from the cross additions. This form of ledger is especially applicable to hotels, on account of the large number of nominal accounts employed to analyse the income derived from various sources; it is also most convenient on account of the fact that it presents the readiest means of keeping each account written 'up to the minute' with a minimum of labour.

CARD AND LOOSE-LEAF METHODS. The great advantages of card and loose-leaf forms of record, from the auditing point of view, are the facts that all dead matter can be systematically elimi-

nated from the ledger and that the various accounts can readily be arranged in a logical and predetermined order.

A great deal has been made by some critics of the possibility of cards, or sheets, being destroyed, and replaced by others containing falsified entries. Where there is a proper system, however, such irregularities would be more speedily detected than would their equivalent under the old-fashioned system of recording all entries in bound books. Bound books are invariably paged or folioed consecutively, but it is safe to assert that no auditor ever conceived it to be part of his duty to make sure that the pages or folios of each ledger were complete. The truth is that the extraction of leaves from a ledger is *possible* whether the ledger be 'loose' or 'bound' and that the same *principles* of internal check against abuse apply, whatever the form of ledger. Loose leaves and cards have now been in use many years and experience has amply demonstrated that the dangers feared when they were introduced were more imaginary than real.

In the case of card and loose-leaf ledgers it is as a rule better to check the postings by calling back from the ledger into the books of first-entry, as time expended in turning from account to account can generally thus be saved; while this sequence enables the auditor more readily to satisfy himself that the ledger, as presented to him for audit, is complete.

MECHANICAL POSTING. In these days, to an increasing extent, mechanical methods are superseding the pen as a medium for ledger posting. This fact does not necessarily affect the auditor's methods of check, for obviously it is just as simple to check a typewritten posting as a posting made with the pen. As a rule, however, when the number of items is sufficiently great to make mechanical methods worth while, the auditor is unlikely to check each individual posting, and will as a rule rely upon the control provided by a system of sectional balancing, coupled with a test by way of samples. Mechanical methods greatly facilitate sectional balancing because they provide means of arriving automatically at totals. The risk of an item having been posted in error to the wrong account still remains, but its importance from the point of view of the auditor is minimised where the ledger is divided into sections because, as a little reflection will show, such an error can remain undetected only where the two accounts concerned are in the same section. In point of fact many ledger posting appliances include automatic safeguards against the danger we are considering. It must always be remembered that machines can only do the work they are told to do and, hence, if originating documents be wrong, all that follows must also be wrong. Therefore attention must always be paid most carefully to the establishment of those documents. As a rule, the general ledger (or its equivalent) will still be posted by hand; but whether that is the case or not, all the entries in this particular ledger require to be checked in detail and carefully scrutinised. While the use of mechanical methods does not in any way alter the principles of auditing, their application may in some respects become more difficult.

If the purchase journal and sales journal are abandoned and the original documents become the posting media, the auditor must vouch the original document with the entry in the ledger. While there should be no special difficulty in tracing an invoice to the ledger, difficulties may arise when the entry in the ledger is the starting-point of the enquiry. An entry in a nominal account may represent the total of a number of original documents which, under a manual system, might be tabulated in one of the analysis columns of a journal. The task of tracing the original document or documents which are required to support an entry in the ledger can be simplified by a suitable system of numbering and classifying the original documents, and by a system of cross-references between documents and ledger accounts. Documents may be more readily traced if they are grouped in batches of reasonable size, the batches being serially numbered.

Where the number of individual items is very considerable, advantage is sometimes taken of Hollerith or Powers-Samas machines to assemble similar items into daily totals and post those daily totals only to the ledger. These machines, if properly used, will provide an automatic check against the posting of an item to the wrong account, and it is suggested that the auditor should satisfy himself that such a safeguard is employed where errors of this description would be important, e.g. if this method be employed in connection with the postings to a nominal ledger. These systems whereby punched cards record transactions are worthy of serious study by reason of their extreme flexibility and capacity for handling unlimited detail. It is possible to use them for every book-keeping process and to produce ledger accounts with automatic accuracy, once the original transactions have been correctly punched on to cards.

✓**STORES AND STOCK ACCOUNTS.** In many businesses it is quite practicable to keep a reliable record of all goods or stores in stock and—wherever this is possible—it is clearly desirable that the auditor should place before his clients the indisputable advantages of such a course.

The details of the construction and working of these accounts form an important branch of the study of book-keeping; but from the audit point of view it may be stated at once that no reliance can be placed on them unless they are capable of being 'keyed up' with the general accounting system. That is to say, where the stores accounts are kept in sterling, it should be possible to establish controlling accounts in the general ledger whereby the detailed balances may be proved by means of totals derived from the financial books of original entry. The ability successfully to apply this check is the best possible proof that the entries in the store books are made on the same rigid system as that governing the financial books.

It must further be stated that the quantities displayed on the detailed store accounts must not be accepted for purposes of the final accounts without the precaution of physical verification; nor must the values be accepted without applying the usual principles of balance sheet valuation. The auditor should inquire what principle is followed in

the pricing of issues and should consider what effect this is likely to have on the relation between book value of quantity balances and the current value thereof.

In the case of some businesses (especially traders dealing in small articles broken from bulk) a regular system of stock accounts is not practicable. In such cases a different method of check must be employed. In every trade there is a well-known percentage of gross profit that ought always to be earned unless very abnormal circumstances arise. If, therefore, the stock account is commenced with the value of the actual stock on hand at the beginning of a period, debited from time to time (usually monthly) with the total purchases, and also with the aforementioned estimated gross profits on the sales, and credited with the sales, the balance shown will represent the stock on hand—estimated on the assumption that the nominal gross profit has exactly been earned. At the periodical stock-taking this estimate can, of course, easily be verified, or corrected. Where an undertaking trades in various kinds of goods, it is always desirable to dissect the sales and purchases, so that the position of the various departments may be perceived and so that differences in the departmental rates of gross profit may be allowed for in the computations.

This system is in very general use and serves three most useful ends. (1) It calls attention to any discrepancy between the actual and nominal gross profits, by means of a similar discrepancy between the ascertained and estimated stock in hand. (2) It affords most useful information as to the probable amount of stock in each department from month to month, and so serves as a guide to, and a check upon, the various departmental managers, as well as affording material for an interim balance sheet, if one be required. (3) It enables considerable errors in stock-taking, or leakages of stock, to be detected and/or prevented.

BAD AND DOUBTFUL DEBTS. An intelligent system of dealing with the difficult question of bad and doubtful debts is of such assistance to all commercial houses that the auditor should lose no opportunity of suggesting that the matter be put upon a scientific basis.

A very good method is the following:

As soon as a debt becomes at all doubtful, or sufficiently overdue to merit special attention, it is transferred to a doubtful debts ledger, which is ruled as follows: On the left-hand page are spaces for two or three ordinary ledger accounts, while the right-hand page is left blank for such memoranda as 'when applied for', 'when sued', 'when failed', and full particulars as to progress of subsequent realisation of the estate. When an account becomes hopelessly bad (either by reason of the Statute of Limitations intervening, or an execution remaining unsatisfied, or a final dividend having been distributed, or a composition accepted), *and not until then*, the account is written off to bad debts account; but on no account should an amount be written off until it is known to be irretrievably bad, as an amount, once written off, is almost certain never to be recovered. It will

be noted that not the least of the advantages afforded by this system is the peculiar prominence it gives to all overdue accounts, thus offering special facilities for their receiving the particular attention they deserve. In a large concern, moreover, it is an obvious advantage that overdue accounts should pass into the control of a special ledger clerk.

Where it is the custom to pass all overdue debts to the solicitor or trade society for collection, their simultaneous transfer to the doubtful debts ledger provides a convenient record that that action has been taken.

The necessary provision for loss upon bad and doubtful debts may be made by means of the provision for bad debts account, which may be credited with an amount such as to bring the total provision to the estimated amount irrecoverable, while the bad debts (nominal) account is debited in the usual way. The memoranda recorded on the blank pages of the doubtful debts ledger will readily afford all available information upon which a proper valuation of the amount necessary to be written off may be prepared, and the systematic focusing of such information upon the method here described will generally admit of a much more reliable estimate being prepared than would otherwise have been practicable.

Some persons prefer to base their valuation upon a certain percentage of the credit sales, and so equalise the loss by charging each year only with an average amount. The argument in this case is that the loss was not really made in the year when it was discovered, but in the year when the sale was effected. The argument is open to question, and, in any event, such a method will not produce a valuation as accurate as one obtained by a careful scrutiny of every account. In any case, the auditor should satisfy himself that the balance sheet he is required to certify does not overstate the amount of the book debts.

THE USE OF THE JOURNAL. The extent to which the much-abused journal may be advantageously employed in modern commercial book-keeping is a question upon the discussion of which so much acrimony has already been unprofitably expended that it is with considerable diffidence that the subject is approached at all.

After all has been said, however, the fact remains that many classes of business may, without any considerable loss of labour, employ the journal for summarising all kinds of general ledger transactions except cash. In such cases—and, be it noted, such cases are referred to only—it appears to be a considerable advantage to pass the cash *totals* through the journal, and so obtain from the journal the sum total of all transactions, which may be then checked against the *totals* of the trial balance, which will be taken out in four columns (upon the French method) for this purpose.

Where this is done, an error in the trial balance may be localised as being either on the debit or the credit side of the ledger, and a considerable amount of time will thus be saved in effecting a final agreement.

It is not, perhaps, very often that this method of balancing by totals will be found to be practicable, but it is, at the same time, much more frequently possible than some would appear to think; and the safeguard it affords against fraudulent transfers in the ledger, between nominal and personal accounts, is an advantage not to be lost sight of where other circumstances are equal.

Where this check of the totals of the transactions is not practicable by means of a regular journal it may often be effected by the auditor constructing an equivalent for the journal from the totals of various other books, and—where this is practicable—the auditor should not let the opportunity escape him.

Generally speaking, entries in the journal represent extraordinary transactions and they should be made only on proper authority. It follows that every journal entry should contain as one of its integral parts a proper narration which should include (a) a statement in pithy form of the nature of the transaction; and (b) a reference to the authority (documentary or other) on which it is based.

SALARIES. The subject of wages has already been discussed and therefore nothing further need be said on that matter here.

Salaries should, in large concerns, be dealt with in a manner as near thereto as practicable. The distinction between wages and salaries turns on the fact that wages are either sums which vary according to the amount of work done (measured either by time or by output) or fixed sums paid for services chargeable directly to production. Salaries on the other hand are usually fixed sums which are not chargeable to production.

A salaries list or book should be maintained to serve the same purposes as the wages book. The reader will perceive that the auditor must exercise the same care over salaries as over wages, notwithstanding that his task is easier by reason of the more regular character of salaries payments. In particular he should require that the salaries book be initialled in token of the actual payment of the sums recorded and every change of rate, or addition of a name, should be authenticated by the signature of a responsible official, or by inspection of an agreement.

Acknowledgements of salaries or wages do not require a receipt stamp.

Salaries can, accordingly, be audited by comparing the weekly (or monthly) totals with the cash book after due authentication by inspection of signatures and by testing of additions. Afterwards the propriety of the individual amounts paid must be established either by inquiring into every change or by agreeing the periodical total paid to every individual as set out in the ledger accounts previously referred to.

Agreements with employees should always be inspected and a careful note made of any provisions therein relating to commissions.

As explained above in connection with wages, income-tax is deducted from salaries under the Pay-as-you-earn system. No further explanation is required here.

AGENTS' ACCOUNTS. Where books are not kept by very skilled book-keepers, the auditor frequently has a considerable amount of additional, and wholly unnecessary, trouble in connection with the accounts between his clients (the agents) and their principals. It is therefore very desirable that agency accounts should be kept upon some definite and practicable system. The conditions of agency are so various that it is impossible to deal in detail here with every conceivable set of circumstances arising in connection with this subject, but it may be pointed out, in general terms, that where the remuneration of the agent is dependent upon the amount of sales or purchases effected by him every consideration of convenience is in favour of a special sold or bought book being employed for his transactions; or, at all events, a special column being devoted to these transactions in the general sold or bought book, as the case may be. When, on the other hand, the remuneration of the agent is by way of profits, or a percentage on the profits earned (whether gross or not), the accounts should be so schemed that an 'agency' account is opened in the general or private ledger, which virtually becomes the trading or profit and loss account in respect of the transactions with which the agent is concerned.

From many points of view there is much in common between agency accounts and consigned accounts, and therefore the considerations obtaining under the latter heading will frequently be found in use in connection with the accounts between agents and principals, and may usefully be consulted before formulating any definite scheme upon which these latter accounts should be kept.

CONSIGNMENT ACCOUNTS. It has been pointed out under the previous heading that the most convenient method of dealing with many agency accounts is so to arrange the books that what is virtually a special trading—or a special profit and loss—account should be kept in respect of these particular items. These remarks apply equally to consignment accounts. Every consideration of convenience requires that in the books of the consignee there should be two accounts for the purpose of recording his transactions with the consignor; the one virtually a trading account, showing the actual result of the trading in the goods consigned, and the other a personal account, showing the position between the consignee and the consignor.

Where several consignments are received from the same consignor, a separate trading account should be opened for each, but one personal account will usually suffice.

The same remarks apply to the books of the consignor himself, except that—as he is dependent entirely upon the consignee for the record of transactions after the goods have once left his office—it becomes possible in some cases to record these transactions in a single account. In the majority of cases, however, it will be found that two accounts are not only more convenient but in the long run involve less time and trouble in the keeping.

A fuller and more detailed exposition of the best method of dealing

with these accounts will be found in the author's *Book-keeping for Accountant Students*, to which the reader is referred.

THE ACCOUNTS OF BRANCH ESTABLISHMENTS. This is a point upon which the auditor will frequently experience considerable difficulty, by reason of the defective system of record employed, and it is therefore of especial importance in connection with auditing that a really practical system of book-keeping should be established.

It may be stated at the outset that the accounts of branch establishments may be ranged under two wholly different categories. In the first case, the accounts of the branch are kept at the branch itself, and are practically independent of those kept at the head office; in the second case, a minimum possible amount of accountancy is employed at the branch, returns being made to the head office, and the transactions of the branch incorporated in the head office books. The latter class of accounts, of course, presents no serious difficulty, and, indeed, for all practical purposes the book-keeping is the same as though the branch establishment did not exist, except that for statistical purposes it may be thought desirable that some of the nominal accounts should be divided up so as to show the transactions of the branch separately for purposes of comparison.

It is, however, with regard to the former class that difficulties are likely to arise. In this connection it may be pointed out that any difficulty or complication which can be conceived may at once be got over if the system of accounts at the branch office be regarded in precisely the same light as though the ledgers recording these transactions were in point of fact kept at the head office in self-balancing ledgers in respect of which adjustment accounts were to be found in the head office ledgers themselves. These adjustment accounts in the head office ledgers, which, of course, will be written up from returns made by the branches, will provide the means of controlling the record of transactions in the branch ledgers, and at the same time combine the whole system of accounts into one entity. On the other hand, there should, of course, be adjustment accounts in the branch office books, so that these themselves may be made self-balancing.

When balancing time comes it is necessary that a trial balance should be taken of the branch books, and remitted to the head office, and this will be found to explain and verify the adjustment account in the head office books dealing with the branch transactions. The trial balance at the head office can then be amplified so as to give effect to these records.

Before leaving the question of branch accounts it may be pointed out that the balance of expediency lies in favour of the branch's bank being a branch of the same bank as that employed at the head office, so that facilities may be afforded for a prompt return being made to the head office of the payments into and out of the branch's banking account. On the other hand, in many cases it will be found preferable not to employ any banking account of the branch at all, but to receive and pay all accounts through the head office alone; and, where the nature of the business makes this possible, every consideration of

expediency will be in favour of it being carried out. In such a case it is always possible for deposits to be made at a local branch bank for transfer to the head office account.

Another point which is well worth bearing in mind, where it can be applied, is that in the case of businesses that deal with the sale of goods in bulk without the bulk being broken, it is of great advantage for the purchases to be all made at the head office, the goods supplied to the branch offices being supplied to them by the head office at selling price. The stock account of the branch office then becomes much simplified, and the balance of such stock account should represent the selling price of the stock actually available on hand, without any adjustments being necessary in respect of estimated or actual gross profit. It is not necessary that this system should at all confuse the question of the profits actually earned by the branch, because there is not the least difficulty in the goods supplied to the branch being credited to a special account in the head office books, instead of being credited to the general sales account. A provision must be made, however, for the gross profit on unsold stock.

The mere fact that a business has numerous branches, instead of merely one, in no way alters the fundamental principles on which the accounts of these branches should be kept; but it need hardly be added that it enormously increases the arguments in favour of these branch accounts being organised and rigidly kept upon a thoroughly sound basis of internal check, and one which renders itself readily available to the scrutiny and supervision of the auditor.

Full details of the manner in which branch accounts should be kept will be found in the author's *Advanced Accounting*.

CHAPTER IV

SPECIAL CONSIDERATIONS IN DIFFERENT CLASSES OF AUDITS

IN the previous chapters the rules laid down have been of as general a character as possible; but it must not, therefore, be supposed that the audit of every concern is to be carried out on precisely the same lines. The opportunities for fraud will vary widely in concerns of a different character, while the chances of unintentional errors of principle and of detail will likewise vary extensively in different classes of concerns.

As has been already intimated, the auditor who wishes to be of the greatest possible service to his client should avail himself of every opportunity to become practically acquainted with the working of the business, as it will only be when he has some real acquaintance with the matter he is discussing that his opinion upon the accounts of any given business will possess any great weight; for if he has no knowledge of the business carried on it is impossible for him to criticise intelligently the system of accounts that records the transactions effected, and if he has no knowledge of the nature of such transactions it is hardly to be expected that he should be in a position to form any reliable opinion as to the risk that exists of the transactions not being correctly recorded in the accounts. These remarks will, perhaps, appear trite to many, but so much has been said about accountants 'confining themselves to their own province' that it has become necessary to point out the inefficiency of any audit which confines its investigations to an inquiry as to the academic correctness of the book-keeping.

The object of the following chapters is not to supply the reader with such special knowledge concerning each class of undertaking as it may be desirable for him to possess before presuming to report on its accounts, but to direct the attention of the reader to those points most worthy of his consideration in each of the leading classes of accounts he is likely to be called upon to verify. The special opportunities of fraud, and the points upon which an innocent misstatement of facts is most likely to occur, will, as far as possible, claim attention, while it may be added that *The Accountants' Library* issued by the publishers of the present work provides a series of handbooks dealing with the accounts of most of the leading industries, and is likely to prove useful to the reader—whether practitioner or student.

With these preliminary remarks, the categorical consideration of the subject will be proceeded with.

AUDIT OF JOINT STOCK COMPANIES. The auditor of a company has the very onerous duty of reporting to the members whether or not the profit and loss account and balance sheet comply with the requirements of the Companies Act, 1948. These requirements are

considered in a later chapter. The duties and rights of auditors under the Act, and the application of the Act to holding companies are also considered in subsequent chapters. In addition to the above matters a number of points arise in the course of the audit of a joint stock company that do not occur in the audit of a private firm, and these points will now be considered under the following heads:

- (a) The audit of share capital and debenture accounts.
- (b) The audit of dividend and interest accounts.
- (c) Compliance with certain statutory requirements.
- (d) Compliance with the memorandum and articles of association, general statutory provisions, special Acts of Parliament, &c.
- (e) The statutory meeting and audit duties in connection therewith.

(a) **THE AUDIT OF SHARE CAPITAL ACCOUNTS.** The main points are: (1) Does the stated amount of issued capital represent a valid allotment to bona fide applicants? To ascertain this, the auditor must see that the amount is within the authorised issue, that the various classes of shares (if there be classes) are in accordance with the memorandum of association and prospectus, that the minutes of allotment are in order, and that the journal entries recording the allotments correctly reflect the minutes; that the allottees have agreed to become shareholders to an extent not less than the amount of their respective allotments, that the aggregate number of shares actually issued to the various allottees is equal to the total number stated to have been issued, and that the required deposit has been paid in cash. (2) Has the amount stated to have been paid up been actually received in cash, or else in kind under a valid contract or memorandum duly registered in accordance with the requirements of Section 52 of the Companies Act, 1948? This requires the auditor to satisfy himself that the minutes making calls are in order, that the amount said to be paid up has actually been received in cash, that a valid contract has been registered for all shares issued as fully or partly paid up, and that shares liable to forfeiture—but not forfeited, appear—so far as can possibly be known—to have been issued to existent persons.

Each class of shares or stock should have an account opened for it in the general ledger, and such account will, in fact, become the adjustment account for that particular share ledger. By this means all transfers are kept out of the general ledger, and—after the issue has once been completed—no further entries are necessary. Should the issue be a large one, however, it is often preferable to open separate general ledger accounts for 'applications', 'allotments', and 'calls', respectively. This system may be assisted greatly by the addition of an extra column to the debit side of the general cash book, the items entered in such column being posted to the share ledger, and the totals periodically extended into the bank column and then posted to the general ledger in the usual way. If this method be adopted, the duplication of entries is reduced to a minimum, and the auditor's work becomes not only proportionately lighter, but also much more certain. In the case of large companies, it is usual to arrange that application and other such money be paid direct to the

bank, by whom it is carried to a special account. This bank account thus operates as a special subsidiary cash account, from which totals can be carried periodically into the general cash book for posting to the general ledger. It will be seen that this system lends itself readily to the method advocated.

For full information upon this subject the reader is referred to the author's *Bookkeeping for Company Secretaries* or *Advanced Accounting*.

PREMIUMS received on the issue of shares must, by Section 56 of the Companies Act, 1948, be credited to a share premium account. By this section, the provisions of the Act relating to the reduction of share capital apply to the share premium account, and it is therefore not available for dividend. It is, however, expressly provided by subsection (2) that the premium may be applied for the purposes of capitalising fully paid bonus shares issued to members. In addition, the following may be written off against the share premium account:

- (a) Preliminary expenses.
- (b) Expenses of, or the commission paid, or discount allowed on, any issue of shares or debentures.
- (c) Any premium payable on redemption of any redeemable preference shares or of any debentures.

Section 56 applies to any premium on shares which were issued before the Act came into force (1st July, 1948), provided that such a premium was identifiable on that date.

If any part of such a premium has been so applied that it does not, on 1st July, 1948, form an identifiable part of the company's reserves, the section does not apply to that part of the premium.

If a premium on shares issued before 1st July, 1948, has been credited to a reserve account together with other items such as a transfer from profit and loss appropriation account, and part of the reserve account has been applied for some suitable purpose, it may not be possible to identify the remaining balance with certainty.

In paragraph 141 of the booklet on the Companies Act, issued by the Institute of Chartered Accountants, an example is given in which a reserve account is credited with £150,000 representing profit appropriations and with £100,000 representing share premiums; the account is subsequently debited with £75,000 'applied for proper purposes', leaving a balance of £175,000.

In the opinion of counsel, there is nothing to show that the £75,000 came from the share premium's contribution to the reserve account. In the absence of any identification of the source from which the £75,000 was provided, 'it cannot be said that any part of the premiums has been so applied that it does not form an identifiable part of the company's reserves, and in our opinion it would be necessary to transfer to the share premium account the full amount of the premiums received, £100,000'.

The share premium account must be shown as a separate item in the balance sheet, as a capital reserve. (I.C.A., paragraph 145.)*

* The abbreviation 'I.C.A.' is used throughout this work to represent the booklet entitled 'The Companies Act, 1947', issued by the Institute of Chartered Accountants. See footnote on page 20.

DISCOUNT AND COMMISSION. Since the 1st January, 1901, it has been lawful for companies making an issue of shares to pay a commission on the underwriting or placing of shares. For the payment to be valid, however, it is necessary that the provisions of Section 53 of the Companies Act, 1948, be strictly complied with. These require that payment be authorised by the articles (at a rate not to exceed 10 per cent. of the issue price); that the amount (or rate) agreed to be paid be disclosed in the prospectus or statement filed in lieu thereof; that the number of shares to which the arrangement relates be similarly disclosed. The amount of commission paid and not yet written off is to be disclosed in every balance sheet. (Companies Act, 1948, Eighth Schedule, paragraph 3 (c)).

The above relates to commissions paid out of the capital or shares of the company. Presumably there is nothing illegal (subject to the company's regulations) in a company applying part of its profits towards the payment of commissions; but, of course, commissions paid for out of profits would necessarily have to be charged against profits, whereas commissions legally paid out of capital may, as a matter of law, be capitalised.

Since 1st November, 1929, it has also been lawful for companies to issue shares at a discount, subject, however, to very stringent safeguards which are now contained in Section 57 of the Companies Act, 1948. The issue must be (a) authorised by resolution of the company, specifying the maximum rate of discount; (b) sanctioned by the Court; (c) made not less than one year from the date when the company was entitled to commence business; (d) made within one month of the date of sanction by the Court, which period the Court may extend; and (e) the issue must consist of shares of the same class as those already issued. All such discount not yet written off must be disclosed in every prospectus relating to the issue of the shares.

By paragraph 3 (e) of the Eighth Schedule to the Act, any such discount not yet written off must be separately stated in the balance sheet.

Debentures may in all cases be issued at a discount, provided the amount thereof (in so far as it has not been written off) is disclosed on the face of the balance sheet.

At subsequent audits it should be ascertained that the balances (i.e. number of shares) on the register of members agrees in aggregate with the total issued as stated in the balance sheet. A *full* examination of the share ledger, and of the transfers registered, is no part of an ordinary audit.

So far as the above remarks apply, they will serve to indicate the auditor's duties with regard to STOCK or DEBENTURES.

REDEEMABLE PREFERENCE SHARES. Before the passing of the Companies Act, 1929, it was a time-honoured and fundamental principle of company law, that, once a share had been validly issued to a holder, the said holder could have his money refunded only on liquidation of the company or under certain types of schemes for reduction of capital approved by the Court. The capital of the company was conceived of as a fund permanently available to satisfy the

liabilities of the company to creditors, and the protection of the creditors was the dominant motive of the law. Section 46 of the 1929 Act effected what appeared to be a revolution by permitting the issue of preference shares which shall be redeemable at the option of *the company*; but the revolution is more apparent than real because one of the conditions precedent to redemption is the accumulation of a fund of profits to take the place of the capital repaid, or the receipt of an equivalent amount of new capital in substitution for the old.

The provisions relating to redeemable preference shares are now contained in Section 58 of the Companies Act, 1948, which provides the following very important conditions which must accompany the issue and redemption of such shares: (a) the issue must be authorised by the articles; (b) the shares can be redeemed only 'out of profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of the redemption'; (c) no shares can be redeemed unless they are fully paid; (d) where shares are redeemed otherwise than out of the proceeds of a fresh issue 'there shall out of profits which would otherwise have been available for dividend be transferred to a reserve fund, to be called "the capital redemption reserve fund" a sum equal to the nominal amount of the shares redeemed'; (e) where shares are redeemed out of the proceeds of a fresh issue, the premium, if any, payable on redemption, must have been provided for out of the profits of the company, or out of share premium account, before the shares are redeemed.

It will be observed that the effect of these provisions is to secure that when capital is repaid an equivalent fund derived either from profits or the proceeds of a new issue shall take its place. The 'capital redemption reserve fund' is obviously of a capital nature and not available for dividend. The interests of creditors are thus amply safeguarded. The Act, however, specifically provides that the fund may be used for the purpose of capitalising fully paid bonus shares issued to members.

Where new shares are issued in substitution for shares redeemed, the new issue does not attract stamp duty even if made within one month before the redemption of the old shares.

It is most important to observe that in every balance sheet of a company which has issued redeemable preference shares, there must be included a statement specifying what part of the issued capital consists of such shares, and the earliest date on which the company has power to redeem those shares.

(b) **THE AUDIT OF PAYMENTS FOR DIVIDEND AND INTEREST** is not usually a difficult matter. A list of members should be handed to the auditor, showing the number of shares held by each on the day up to which the dividend was declared, and the amount of dividend due. The additions of this list should be checked, and the totals agreed with the amounts of shares issued and dividends payable respectively; it must also be seen that the rate of dividend

is correctly calculated *in toto*. In the case of interest on debentures, income-tax must have been deducted; dividends are usually expressed as a net amount, i.e. after deduction of income-tax. A few of the larger amounts, taken at random, may advantageously be compared with the share ledger, and the calculations checked; but it is not generally essential that the whole list be exhaustively verified. Many companies draw one cheque for the whole amount of the dividend, and pay it into a separate banking account, against which the dividend warrants are issued. Where this method is adopted, it is a comparatively simple matter to vouch the payments and verify the amount of outstanding dividends—which latter will, of course, agree with the balance of the (special) pass book. Where dividends are paid by cheque upon the ordinary banking account, the vouching becomes merged in the vouching of the general payments. The outstanding dividends will not be so easily traced, but will present no special difficulty that requires particular mention here.

Interest on debentures presents no further points for consideration; but it is particularly necessary to bear in mind that income-tax must always be deducted from interest, and from dividends on preference shares, or the ordinary shareholders will suffer an injustice.

(c) THE VARIOUS STATUTORY REQUIREMENTS above referred to, together with the several sections enforcing their use, are as follows:

So far as companies registered under the Companies Acts are concerned:

(a) Register of members (*vide* Sections 110 and 111 of the 1948 Act).

It is noteworthy that companies with more than fifty members must keep an index of the members; the register may be in such form as itself to constitute an index.

(b) Register of mortgages (Section 104).

(c) Minute books (Section 145).

(d) Register of directors and secretaries (Section 200).

By Section 176, every public company registered on or after 1st November, 1929, must have at least two directors; every public company registered before that date and every private company whenever registered, must have at least one director. By Section 177 (1), every company must have a secretary and a sole director may not also be secretary. For the purposes of Section 200, and also of Section 195 (see below), a person in accordance with whose directions or instructions the directors of a company are accustomed to act shall be deemed to be a director and officer of the company. By Section 455 (1) the expression 'director' includes any person occupying the position of director, by whatever name called.

(e) Register of directors' holdings of shares and debentures including, in the case of a company which is a member of a group of companies, shares or debentures of any other member of the group. (Section 195.) A group of companies consists of a holding company and one or more subsidiaries.

(f) Annual return. (Sections 124 to 129 and Sixth Schedule.)

The annual return must include, *inter alia*, a summary of the share capital and debentures, a list of persons who were members on the fourteenth day after the annual general meeting and of persons who have been members at any time since the date of the last annual return. Particulars of directors and secretaries must also be included. There must also be annexed to the annual return a copy, certified as a true copy by a director and the secretary, of every balance sheet laid before the company in general meeting during the period to which the return relates, together with the profit and loss account, the auditors' report and the directors' report. The return must be lodged with the registrar of joint-stock companies, and is there placed on the file for the company. The file may be inspected by any member of the public on payment of a fee of one shilling. Until the Companies Act, 1948, came into operation, private companies were not obliged to file a copy of their accounts with the annual return. This important privilege has been withdrawn except in the case of 'exempt private companies'. The definition of an exempt private company is contained in Section 129 and in the Seventh Schedule. For further details the reader is referred to Chapter VIII.

(g) By Section 147 (1), every company shall cause to be kept proper books of account with respect to:

- (i) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place;
- (ii) all sales and purchases of goods by the company;
- (iii) the assets and liabilities of the company.

By subsection (2) of the same section, the books must be such as are necessary to give a true and fair view of the company's affairs and to explain its transactions. By subsection (3), if books of account are kept at a place outside Great Britain, accounts and returns sufficient to disclose with reasonable accuracy the financial position of the business must be sent to Great Britain at intervals not exceeding six months. These returns must be such as will enable the accounts of the company to be prepared in accordance with the Act.

It is provided by Section 331 that if proper books of account were not kept by a company throughout the period of two years immediately preceding the commencement of its winding up or the period between the incorporation of the company and the commencement of the winding-up, whichever is the shorter, every officer of the company who is in default is liable on conviction on indictment to imprisonment for a term not exceeding one year, or on summary conviction to imprisonment for a term not exceeding six months, unless he shows that he acted honestly and that in the circumstances in which the business of the company was carried on the default was excusable.

For purposes of Section 331, proper books of account shall be deemed not to have been kept if there have not been kept such books or accounts as are necessary to exhibit and explain the transactions and financial position of the trade or business of the company, including books containing entries from day to day in sufficient

detail of all cash received and cash paid, and, where the trade or business has involved dealings in goods, statements of the annual stock-takings and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient detail to enable those goods and those buyers and sellers to be identified.

The Companies Act does not impose any specific duty upon auditors in regard to the various registers, minute books, and annual return. Nevertheless, the auditor should satisfy himself that the records are kept in the prescribed form and, *prima facie*, correctly. In addition, he will do well to ascertain that all mortgages and charges that require registration have been fully entered in the register of mortgages, and that the annual return has been filed with the registrar of joint-stock companies.

With regard to the books of account, however, precise obligations are laid upon the auditors. By Section 162 (1) of the 1948 Act and the Ninth Schedule, the auditors must state in their report 'Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them'. They are also required to state whether the balance sheet and profit and loss account are in agreement with the books of account and returns.

It is provided by Section 436 (1) of the 1948 Act that any register, index, minute book or book of account required by the Act to be kept by a company may be kept either by making entries in bound books or by recording the matters in question in any other manner. It is therefore clear that any book, register or index may be in card or loose-leaf form. The need for providing safeguards against falsification is recognised by Section 436 (2), which provides that where records are not kept in a bound book, adequate precautions shall be taken for guarding against falsification and facilitating its discovery.

The provisions of the Companies Act as to prospectus, allotment, statutory meeting, audit, &c., should also be carefully followed.

Companies incorporating the Companies Clauses Act, 1845—that is to say, almost all companies incorporated by special Act of Parliament—are required to keep the following:

- (a) Register of shareholders (Section 9).
- (b) Shareholders' address book (Section 12).
- (c) Register of holders of consolidated stock (Section 63).
- (d) Register of mortgages (Section 43).
- (e) Register of transfers (Section 15).
- (f) Minute book (Section 98).

The particulars required to be contained in each of these books may be ascertained upon reference to the sections named, which are reproduced in full in Appendix A.

In the case of all companies the following statistical books are practically indispensable, whether required by statute or not:

Shareholders' and debenture-holders' address books (or index).

Share ledger.

Debenture ledger.

Transfer registers (for shares and debentures).

Directors' attendance book.

Applications and allotments book (one for each class of shares or debentures).

Call books (ditto).

There is no reason whatever why any of these should not be in 'card' or 'loose-leaf' form, if preferred.

(d) COMPLIANCE WITH THE MEMORANDUM AND ARTICLES OF ASSOCIATION, SPECIAL ACTS OF PARLIAMENT, OR DEED OF SETTLEMENT. Under this heading it is difficult to draw attention to specific points. It may be mentioned, however, that it is not merely expedient, but also absolutely necessary, that the auditor should carefully read such of these documents as may relate to any particular audit, with a view to modifying his course of action accordingly. The special points to which it will be necessary for him to direct attention are, so far as the capital is concerned, whether it has been duly authorised and expended upon the objects for which the company was formed; so far as the accounts are concerned, that any special points raised in these documents are borne in mind when considering the method upon which the accounts have been framed; and, so far as the question of profits available for dividend is concerned, as to whether all stipulations as to certain profits being carried to reserve or applied (say) to the future redemption of debentures, have been dealt with properly.

In the case of companies registered under the Companies Acts, it is also desirable that particular attention should be directed to the various contracts connected with the original formation of the company. In all cases the prospectus, or statement in lieu thereof (if any), should be very carefully read, with a view to seeing that any special provisions laid down therein have been acted on. It is naturally difficult, if not actually impossible, to speak exhaustively in this connection; but it may be mentioned that, supposing a prospectus states that the directors will not take any fees unless the company has made profits, or until a certain dividend has been paid to shareholders, then—whether or not a similar provision is contained in the company's articles of association or special Act of Parliament—it is necessary that the auditor should see it has been complied with in the accounts which come before him. On this point, however, nothing more than general statements can here be made.

The regulations of companies with regard to the appointment, rotation and remuneration of directors are of the utmost importance, as are any provisions limiting the powers of the board or of any members thereof. The auditor should satisfy himself that the directors acting during the period under audit have been validly appointed. It is important to note, however, that by Section 180 of the 1948 Act, it is provided that the acts of a director or manager shall be valid notwithstanding any defect that may afterwards be discovered in his appointment or qualification. Two innovations introduced by the

Act of 1948 are of special interest in this connection, and may be noticed here. First, Section 184 provides that a company may by ordinary resolution remove a director before the expiration of his period of office, notwithstanding anything in its articles or in any agreement between the company and the director; this does not apply to any director of a private company who on 18th July, 1945, held office for life. Secondly, Section 185 provides that no person who is more than 70 years of age may be appointed a director, and provides for the compulsory retirement of directors upon attaining the age of 70. Section 185 does not, however, apply to private companies, and other companies may by their articles of association, exclude the operation of the section. It is also expressly provided that the acts of a director shall be valid notwithstanding a subsequent discovery that his appointment had terminated under the age limit provisions. It is necessary to verify that the remuneration drawn by the directors is duly authorised by the articles; if the articles are silent then the authority of a general meeting is alone sufficient to vote any remuneration whatever. Further reference to this matter will be made in Chapter VII of this work.

(e) **THE STATUTORY MEETING.** None of the provisions now to be considered applies to private companies. Otherwise, under Section 130, every company limited by shares and every company limited by guarantee and having a share capital must, within a period of not less than one month nor more than three months from the date at which the company is entitled to commence business, hold a general meeting of members called 'the statutory meeting'. At least fourteen days before the meeting every member must be provided by the directors with a report called 'the statutory report'. If the statutory report is circulated at a date later than fourteen days before the meeting it may nevertheless be deemed to be validly circulated if so agreed by all the members entitled to attend and vote at the meeting.

The statutory report is to be certified by not less than two directors and must state:

- (a) The total number of shares allotted, distinguishing shares allotted as fully or partly paid otherwise than in cash, and stating in the case of shares partly paid up the extent to which they are so paid up, and in either case the consideration for which they have been allotted;
- (b) The total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid.
- (c) An abstract of the receipts of the company and of the payments made thereon, up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company.
- (d) Particulars as to directors, auditors, managers and secretary of the company; and

- (e) Particulars of any contract the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

The interest of the statutory report for our present purpose lies in the fact that under Section 130 (4) it must 'so far as it relates to the shares allotted by the company and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, be certified as correct by the auditors, if any, of the company'. It will be seen that an important and responsible task has to be discharged with great expedition. The duties involved may be summarised as under:

- (a) The actual applications must be vouched with the application sheets and the cash recorded thereon must be agreed with the banker's pass book.
- (b) The minutes of allotment must be examined and checked to the relative columns of the application sheets, the consequent cash being agreed with the banker's pass book. Similar remarks apply if any calls have been made.
- (c) Cash returned to unsuccessful applicants must be vouched and agreed with the banker's pass book.
- (d) Where shares are issued to nominees, the authority so to allot and the acceptances of the allotments must be inspected.
- (e) Where shares are issued otherwise than for cash, the contract must be seen and the auditor must be satisfied that it has been filed with the registrar.
- (f) The auditor must be satisfied that the minimum subscription has been reached before allotment and that the number of shares issued is within the authorised capital.
- (g) Receipts from debentures must be vouched with the pass book and the minutes relating thereto.
- (h) All payments must be vouched. In this connection it must be borne in mind that certain of the preliminary expenses may be payable by the vendor.
- (i) The balance remaining must be verified by banker's certificate.

As to the abstract of receipts and payments, it will be clear that there is no need to classify the receipts and payments on revenue account.

The usual form of the auditor's certificate is: 'We hereby certify that so much of this report as relates to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, is correct.'

II. COMMERCIAL ACCOUNTS. (a) MERCHANTS AND WAREHOUSEMEN. The chief openings for fraud in these accounts are: theft from stock; mis-statement of cash sales; fraudulent payment of bogus purchases; misappropriation of moneys received in payment of accounts—such accounts being either left open or written off as

bad; petty theft by raising fictitious items of discount allowed on receipts, or bank charges or interest incurred on payments; and similar matters. Of what may be styled 'innocent' errors, the most common are errors of principle in the valuation of stock-in-trade; insufficient depreciation of fixed assets; omission to allow for accrued discounts and interest; errors of principle in dealing with foreign currencies; omission of liability on outstanding expenses, and on bills discounted; insufficient provision for bad debts, &c. The auditor will do well to ascertain the terms of payment and discount accorded to, and by, his clients, and to make use of this knowledge continuously. Where the terms vary they should be written in red ink at the head of each account in the ledger. The auditor should make himself acquainted with the percentage of gross profit expected by his clients, and should compare it, both with the actual results and the rate generally realised by others in the same trade. Stock accounts, *can*, almost invariably, be kept by merchants and warehousemen; but, in practice, the full possibilities of these accounts are often not realised.

The question of patents or trade-marks sometimes arises in these accounts, but the consideration thereof is more appropriately dealt with in a later chapter. In a foreign merchant's business consignment accounts and bill transactions will frequently assume considerable proportions; wherever possible they should be fully checked in detail.

(b) MANUFACTURING TRADERS. Under this heading are intended to be included those manufacturers who ordinarily keep a stock of ready-made articles, and who do not manufacture exclusively (or principally) 'to order'. Such manufacturers are, clearly, also warehousemen, and consequently the preceding paragraph (a) will apply to the consideration of their accounts; but a few additional precautions are required in connection with their manufacturing departments.

The item of wages, in particular, is one requiring the utmost care; and the question of depreciation of plant and machinery will also require a full share of attention. A proper system of 'costing' becomes all but essential. It is probable that the auditor will find some such system in operation; but it is at least possible that the actual system employed will be found both unscientific and unreliable.

(c) RETAILERS. RETAILERS WHO GIVE CREDIT in many respects follow upon the same lines as the wholesale houses in the same trade; but the increased number of transactions renders a detailed audit more difficult. It is generally quite impossible to call back all the postings of the sold ledger; but the *balancing* thereof can be checked without difficulty, and must always be done. Where practicable the posting of the cash received may be checked with advantage, and the list of balances should always be compared with the ledger, and the additions checked. Where the business is very voluminous, the auditor must perforce rely on the system of internal audit; but, in any case, the auditor should not lose his grip of this department, and should occasionally check the balances himself. To check, say, one or two ledgers

at random each year will have all the moral effect of checking the whole set.

Many retail houses supply goods to their own assistants, &c., at reduced rates, and allow credit until the following pay-day. A separate 'assistants' ledger' should always be kept in these cases, and the auditor is usually expected to see that the payment of these accounts is not unduly delayed. At every stock-taking he should be careful to ascertain that no amount stands to the debit of an employee who has left. These transactions merit special treatment in the trading account in order that the ratio of gross profit may not be disturbed.

The bought ledger is generally of comparatively manageable proportions; consequently, it is rarely impossible to check it *in toto*. In any case, the bought ledger payments should be checked, both as to postings and vouchers. In a continuous audit it is frequently arranged that the auditor shall pass all the bought ledger statements for payment, and the system has much to recommend it. In addition to seeing that each item on the statements is also in the ledger, the auditor should make the ledger-keeper initial—and so guarantee the correctness of—every statement that is submitted by him. The auditor should also compare the discount deducted with the terms of payment stated at the head of each account in the ledger. It need hardly be added that this passing of the bought ledger statements for payment is not an integral part of any audit, and—where performed—it should command a special fee.

The examination of petty cash has already occupied attention, and it therefore only remains to add that—in addition to vouching for the bona fides of all payments—it is essential that some responsible person be made accountable for the correctness of the dissection of the items.

The departmental accounts must not be lost sight of, as they form one of the most important branches of the auditor's duties. An account showing the sales, purchases, and estimated stock should be submitted to the principals each month, and the preparation of this account frequently devolves upon the auditor. At the stock-taking the reconciliation of the estimated figures with the actual stock on hand may also profitably occupy the auditor's attention.

The postings of the private ledger should always be called back, and it is highly desirable that such private ledger should contain, within itself, all the materials for a trial balance.

Bills receivable will but rarely be found in connection with a retailer's business, but bills payable may exist, and will require attention.

The vouching of payments for salaries must not escape attention, but it calls for no special comment here.

In CASH BUSINESSES the problem is somewhat simplified by the considerable reduction effected in the number of sold ledger accounts. Indeed, these accounts disappear unless they remain, in essence, as deposit accounts kept by regular customers who wish to avoid the trouble of remitting with every order. It is an important part of the auditor's duty to see that deposit accounts are not allowed to become overdrawn without proper authority.

The system adopted for checking the accuracy of the cash takings

will, as before, require the auditor's careful consideration; but, in the absence of any special arrangement to the contrary, it is not necessary for him to carry his investigation into the accuracy of such takings beyond (a) seeing that the system in use is properly carried out; (b) seeing that the total amounts are duly banked; (c) making an occasional test examination of particular periods, in detail, with the original documents relating to the matter.

It is very usual for credit notes to be issued against goods returned by customers; and, as these credit notes may be used in payment of subsequent purchases by the customers, or the money therefore obtained upon application to one of the cashiers, the question has to be dealt with by the auditor. It is sometimes arranged that, at the end of the day, the petty cashier shall redeem all credit notes in the hands of the receiving cashiers, the amounts being charged up through petty cash. The issue of credit notes must, therefore, be guarded carefully against abuse; and it is essential that the system under which the various departments are debited with their respective returns be properly arranged. The credit notes should always be compared with the counterfoils, and presented to the auditor for cancellation.

(d) **CONTRACTORS.** Under this heading the accounts of those manufacturers who keep little or no ready-made stock will be dealt with. This class includes builders, engineers, shipbuilders, &c.

In these accounts the cost of—and profit or loss arising from—each contract will require to be separately stated; the contractor, in fact, opening a special account for every contract. Cost accounts thus form an especial feature of the contractor's books, and an inquiry into the principles upon which they are based is thus a most profitable occupation for the auditor.

The systems upon which stores are issued and wages booked and paid are also of the greatest importance; and time spent upon such an inquiry is likely to be of considerably greater advantage to the client than any detailed examination of the books.

The extent of the auditor's examination into detail will be a matter depending largely upon the nature and magnitude of the undertaking.

The same rules which have already guided the auditor as to the extent of his inquiry into details will serve him here; the larger the undertaking the more its opportunities of internal check, and consequently the less necessity for the skilled auditor to check every detail. Many large undertakings keep their own staff auditor, who is responsible for the technical accuracy of the trial balance.

The valuation of contracts in hand and the calculation of depreciation are both matters of the greatest importance, but they will be more conveniently dealt with at a later stage.

(e) **BREWERIES.** Although the audit of a brewery is a matter concerning which some experience upon the part of the auditor is especially desirable, it is by no means easy to indicate, in a few words, the salient features of the task before him.

Thefts of stock and of collections are perhaps the two main risks run

by brewers. The former is best guarded against by properly designed stock accounts, and the comparative statistics deducible therefrom, combined with a certain amount of practical knowledge. The second risk arises from the fact that accounts are frequently collected by the draymen; the matter therefore requires great care, but it presents no exceptional features. The discounts allowed must not be passed without inspection, however, for, being variable, they can easily be juggled with.

In connection with tied houses, the auditor should see that all the revenue receivable from this—as well as from every other—class of investment is brought into the account, subject only to due provision for bad and doubtful debts. In some cases loans may be due from the tenants of these houses, and in connection with these loans, provision against loss is a matter of considerable importance, and one requiring the most careful consideration. It should, moreover, be borne in mind that the limit of possible loss may greatly exceed the amount actually advanced, inasmuch as the brewery may have guaranteed a loan obtained by the tenant, which forms a first charge upon the property. The aggregate amount of such guarantees should in all cases be stated upon the balance sheet as a contingent liability.

Another point of considerable importance is the question of depreciation. In the case of a brewery plant the actual wear and tear is probably less than in the case of most undertakings, because the plant will not be working every day, and thus—apart from the fact that it is running a comparatively small number of hours per week—the intervals of rest afford facilities for making satisfactory and permanent repairs to a far greater extent than is practicable with most other undertakings. The result is that a brewery plant can in practice be kept at a very high state of efficiency by careful and reasonable repairs and renewals. On the other hand, some items are especially liable to depreciation by becoming obsolete, and this important fact should not be lost sight of.

(f) HOTELS. The accounts of hotels, whether belonging to companies or to private persons, do not call for any extended comment. The auditor who is accustomed to hotel accounts will be able by a careful examination of the items comprised in the profit and loss account to form a fairly reliable opinion as to whether or not any leakage exists. If there appears to be any reason to suspect that things are not as they should be, it might be found desirable to examine in detail the charges for a portion, at least, of the period under consideration; but, under ordinary circumstances, it is not usual to carry the investigation *behind* the visitors' ledger except for the purpose of verifying the cellar stock books. Proper stock accounts ought always to be kept of wines, spirits, &c., and these should be carefully inspected, especially if the profit and loss account does not show an adequate return on this department. Where the book-keeper is also the cashier, especial care must be exercised to ascertain that all receipts are properly accounted for; and it is also important to see that the petty cash disbursed on behalf of visitors has been duly charged to their

respective accounts and collected. The entries in the tradesmen's, nominal and private ledgers should always be thoroughly checked; and especial care should be given to the vouching of all payments, including wages.

The question of depreciation—here, as elsewhere—is also a most important one, and must be carefully considered. Such items as bedding and linen, plate, cutlery, china and glass, &c., are frequently revalued for each balance sheet, instead of being depreciated regularly; but perhaps a better plan is to debit profit and loss account and credit renewals account with a fixed (ample) provision for renewals, the actual expenditure being debited to renewal account, and any credit balance treated as a provision. The advantage of this course is that it equalises profits, so that a period of five years could be averaged; but it is well for the auditor to satisfy himself that the amount written off against revenue is ample for all ordinary contingencies, therefore an occasional revaluation is most useful.

PUBLIC HOUSES follow, in many respects, the same lines as hotels. The accounts are, in some ways, simpler; but, on the other hand, they are generally less complete. An experienced auditor may prove himself of considerable value to the proprietor of a public house, but he cannot pretend to protect him against fraud on the part of his employees; neither is it always possible for him to detect any fraud that may have been committed. He can, however, prepare—or superintend the preparation of—accounts that will show exactly *how* the net profit has been earned, and these accounts will suffice the experienced client, for he knows exactly what result ought to have ensued from a given turnover, and so can judge for himself as to the satisfactoriness of the existing management.

With regard to the effect of the Licensing Acts on the accounts of undertakings owning licensed properties, it is thought that all annual payments to the compensation fund should be treated as revenue charges; if a licence is withdrawn and compensation received in respect thereof, the transaction should be treated as though the licence lost had been *sold* for the sum received, thus resulting in a loss chargeable against revenue or a divisible profit, as the case may be. This statement must probably be qualified if the extinguished licence had been the subject of a debenture charge. If licences belonging to neighbouring competitors are withdrawn, an indirect benefit may quite possibly result; but such benefit (if any) does not appear to be sufficiently definite or direct to justify the capitalisation of any portion of the annual payments made to the compensation fund under the Acts.

(g) CLUBS. The accounts of clubs follow very much upon the lines previously indicated with regard to hotels; but there are one or two points with which it seems desirable to deal in a little further detail. In the business of an hotel it is, of course, practically impossible for the proprietors to rely upon their customers in any way to assist them in checking their employees; but, in the case of clubs—and particularly members' clubs where the members themselves are the proprietors of the undertaking—the accounts can be, to a certain extent,

modified with advantage with a view to devising a system by which the members themselves may, to a certain extent, check fraud upon the part of employees.

In many clubs the system obtains of requesting members after they have paid their bills at the cashier's desk in the coffee room to place the receipted account in a locked box standing near. The receipted accounts thus form vouchers which can be utilised as the best possible check upon the cashier himself. In the billiard-room, too, it is a very usual custom for members to be asked to place their table-money in a locked box, instead of giving it to the waiter, as is invariably done at hotels; and by this means one of the chief difficulties which arise in connection with hotels is obviated, it being well known that in many hotels the proprietors do not get the benefit of the full earnings of the billiard tables. Other points of a similar description will frequently suggest themselves to the auditor from time to time. To a great extent they will assist him in making his audit more thorough, and will sometimes enable him to dispense with details of checking which otherwise would be absolutely necessary.

In connection with the cellar, also, the accounts of clubs present an advantage over those employed by many hotels, viz. that all orders for drinks have (frequently) to be signed by the members, and are thus available as vouchers for verifying the taking of wines and spirits out of stock. It may be added, however, that this is a system which is used by some hotels, although many dispense with it on the ground that it is difficult to get their customers to take the necessary trouble.

In this connection the treatment of subscriptions received from life-members, and of entrance fees received from annual members, raises a point of some interest. It is not unusual to find that the life subscriptions and entrance fees received are credited to the revenue of the current year. It is clear, however, that this practice is incorrect. In the case of the great majority of institutions of this description it is possible to justify the practice—however incorrect it may be upon theoretical grounds—by reason of the fact that, so far as it is humanly possible to foretell the future, there seems every reason to suppose that the receipts under these headings will be practically constant from year to year; but in the case of a new institution it is obvious that the receipts under these headings will be far larger than the receipts of normal years, and in such cases at least they ought to be capitalised, for there can be no doubt that, properly regarded, they represent a payment in advance in respect of benefits to be received during a number of years. In the case, however, of institutions not formed for purposes of profit, and therefore paying no dividends out of profits, the matter is only of importance in that an appearance of fictitious prosperity may be conveyed by the revenue accounts of the earlier years, when receipts under this heading are obviously above what may reasonably be expected to be the normal average figure.

(h) THEATRES, &c. The most difficult feature in theatrical and similar accounts (from the auditor's point of view) is the large amount

of cash—i.e. coins and notes—which is necessarily handled by all persons connected with the financial part of the management.

It is not usual for the auditor to be expected to verify the cash takings. this office is usually performed by the treasurer, or (in a touring company) by the business manager, who is considered a sufficiently responsible person for the performance of a function that requires integrity, certainly, but not great technical knowledge. It should be an invariable rule that all sums received are banked at least once a day, and the auditor will probably find no great difficulty in securing the adoption of this plan. Where this is done he will, of course, satisfy himself that the amounts so banked agree with the various returns that have been certified by the treasurer. As these returns have not been prepared by the treasurer himself, they form a fairly reliable check upon that official, and—under a properly arranged system of internal check—are sufficient for all practical purposes.

Payments may be roughly divided into three classes: (1) mounting expenses; (2) advertising; (3) running expenses, viz. (a) salaries and wages, (b) rent, light, &c. The first will almost entirely be paid by cheque, against accounts properly certified by the manager, and call for no special comment. The same remark applies to advertising, which, by the way, is almost invariably done by a contractor. Salaries and wages are always paid in cash, usually weekly; separate pay sheets are drawn up for (1) 'front of house', &c.; (2) principals; (3) chorus and ballet; (4) 'supers'; (5) band; (6) wardrobe; (7) carpenters, &c. It is a good plan to have separate cheques drawn for each of these headings, and to let every employee sign for the amount paid him. 'Supers' do not usually sign for their wages, however, the super-master's signature being accepted for the whole amount paid. (In exceptional cases, however, the salary of some great 'star' will be paid into his or her banking account direct; such transactions are, of course, easily vouched.) It is not usual for the auditor to verify the composition of the pay sheets, but there would be no harm done, if he did so occasionally—and unexpectedly.

Advances, or 'subs.' are frequently made to members of touring companies (and occasionally also in town companies), and it often happens that the result is chaos. The auditor will do well to inquire into the system in vogue as regards 'subs.' and to see that it is such that the paymaster (and not the proprietor) loses by any careless omission to recover a 'sub.' out of the following week's salary.

The valuation of assets, especially of copyrights and performing rights, is, perhaps, almost the most ticklish matter in connection with theatre audits; but the subject is so technical that it is necessary to dismiss it with a passing caution against over-valuation. It will be best for the auditor expressly to state in his report that he does not accept any responsibility for the values placed upon these items.

When a company is 'on tour' (and companies appearing in suburban theatres come within that term), the usual arrangement is to divide the gross receipts in fixed proportions (generally half each) between the 'company' and the provincial lessee, the latter paying rent, light, &c., also 'front of house' and carpenters' wages (sometimes,

also the band), and advertising. The duties of an auditor acting for either side are thus somewhat reduced. When acting for the representatives, or proprietors, of the touring company, he will base his item 'gross receipts' upon the joint certified return of his client's business manager and the provincial treasurer (who is, not infrequently, stage manager and lessee as well). He must, of course, see that the proper percentage of these gross receipts is duly accounted for.

Refreshments and advertising on programmes are usually sublet.

(i) PUBLISHERS. The audit of publishers' accounts presents a peculiar combination of complications. In many cases publishers do their own printing, and in this respect their business is similar to that of manufacturing traders (see under heading I (b) above). Almost invariably, however, they will also be retailers, and then the considerations detailed under heading I (c) will also apply. Many houses add the further occupation of trading—either wholesale or retail, or both—in the publications of other firms, which, to a great extent, brings them under the heading I (a) above; whilst almost every house will occasionally undertake the publication of authors' works upon such terms, as to royalty, &c., as make it absolutely necessary that both stock accounts and cost accounts should be carried to perfection. In this respect, publishers' accounts involve many of the considerations discussed under heading I (d) when dealing with contractors' accounts.

A complete audit of publishers' accounts is, on account of the multiplicity of detail involved, a practical impossibility; the extent to which a partial audit may advantageously be carried must, on the other hand, of necessity vary with almost every individual case. The considerations involved in the previous paragraphs are the only ones that can be offered; but it may be added that here—as in the case of all other partial audits—the precise routine may be *varied* from time to time with the greater advantage.

Advertisements inserted in books, and also in magazines, are a source of income that must not escape attention. It frequently happens that the whole space has been sold out-and-out to an advertising contractor which will naturally simplify the auditor's work to a great extent; where, however, a firm of publishers runs its own advertising department—an unusual occurrence with books, but not an infrequent practice with magazines and reviews—the procedure follows that of the newspaper audit, which will be considered next. As to how far the auditor need go into detail here must again be left greatly to his own discretion and the circumstances of the individual case.

Permanent assets, such as buildings, plant, &c., must, of course, be subjected to proper depreciation, and stock-in-trade will require carefully valuing. It ought to be possible for the auditor to obtain absolute proof as to the *quantity* of stock-in-trade, but he can hardly be expected to check the inventory *in extenso*. The prices set upon unsold publications should never exceed the cost of production, and—in the case of periodicals at least—only a certain number are really worth more than waste-paper price.

Care should be taken to ascertain that the stock list is not inflated

by unsaleable publications that are not worth anything like the cost of production.

With regard to the valuation of copyrights for balance sheet purposes, it is usual for a separate account to be opened for each publication, which is, in the first place, debited with the actual cost of production, including, of course, the printing, binding, illustrations, &c. (and, where the copyright is purchased, the purchase price thereof, together with that of any stock which may have been taken over therewith). Many firms at balancing time review the debits to the various copyright accounts, depreciating some and appreciating others; that is to say, the system is adopted of valuing the copyrights by inventory at each period of balancing, wholly irrespective of the actual cost. It is, of course, very desirable that where necessary the cost should be written *down* from time to time; but the arguments with regard to writing up the value of a copyright are precisely those which might be—and, indeed, should be—invariably used *against* writing up the value of the asset goodwill and crediting the difference to profit and loss account. It may be perfectly true that a large revenue is expected from this asset in the future; but that in itself can afford no possible argument for anticipating that revenue, and taking credit for it in the current period. On the other hand, it will probably be generally admitted that no great harm can be done by writing up such copyrights as have appreciated, so long as the actual effect of so doing is not to increase the book-value of copyrights as a whole. In this connection it may be mentioned that in many houses there is a good general rule in use, to the effect that the value attached to any copyright should not exceed three years' purchase upon the gross profit earned therefrom during the past year.

Sometimes, even when a publication is itself a failure, some residual value will attach to illustrations, &c., which have been used in its production. It is very important, however, that no fictitious estimate should be put upon the value of such doubtful assets as these, and of the two it seems preferable that they should be stated at *nil* in the balance sheet.

The value of artists' original drawings (for illustrations) is often considerable, and has not infrequently been found to exceed the price originally paid for both original and copyright. It is hardly safe, however, to reckon such originals as assets—if valuable, they will generally be sold, and, if retained, the most that can be said is that they have a latent value.

On behalf of his clients it may be thought desirable for the auditor to check thoroughly all royalty accounts, but this does not form part of a regular audit.

NEWSPAPERS AND PERIODICALS present a few special features. In the absence of a staff auditor, the auditor will require to satisfy himself that every advertisement is eventually paid for (unless, of course, a bad debt has been made), or else that it has been franked as 'free' by some responsible person. The commission accounts of agents and canvassers should also always be examined.

The 'inside' of a paper is the work of the regular staff, or of

'contributors'; the former are paid a regular salary (usually), the latter are paid for the actual work done. It would be a desirable thing to make sure that a contributor was never paid for a sub-editor's work, but no auditor could ever ascertain such a thing for himself, and he must therefore rest content with the certified contributors' accounts as they are submitted to him.

It frequently devolves upon the auditor to prepare weekly, or monthly, statements, showing approximately the income and expenditure. Such work naturally commands a special fee.

The printing of the publication calls for no special comment here; when done by the proprietors they will, of course, be printers as well as publishers, and the auditor must take his stand accordingly.

The number of copies printed, issued, returned, exchanged, distributed free, and in stock, should always be certified by the publishing manager. From his returns the trade ledger debits may be vouched.

Every periodical is started at a loss, and it is usual to debit this loss to an establishment account; when the concern pays—and so acquires a goodwill—the cost of such goodwill is represented by the amount to the debit of establishment account, which thus virtually becomes a goodwill account. There is no great objection to this system, and it is much in favour on account of the information it affords to the intending purchaser of a recently established paper; but, when a periodical is once fairly started, the auditor should require a very good reason to be furnished him before he sanctions the transfer of an unexpected loss to the establishment account: if such loss arises from an increase of matter (in quantity or quality) or a reduction in price, it may be in the nature of capital outlay, as tending to increase the permanent value of the concern, but an *unexpected* loss is likely to have the contrary effect.

III. MINING ACCOUNTS. (a) FOREIGN MINES. It should be ascertained that all mining regulations of the foreign (or Colonial) government have been complied with, and all taxes and licences paid.

It is not usual for the auditor to visit the works of a foreign mine. The general manager remits periodically a certified return of his receipts and payments, which is incorporated in the accounts kept at the head office. Such accounts are not usually very voluminous, and are generally examined by the auditor *in toto*. It is, of course, desirable that all expenditure at the works be properly vouched, and for the auditor to examine these vouchers. To make such an examination really effective, some knowledge of the language locally spoken is, of course, highly desirable; but it is of no use for auditors to conceal (from themselves) the fact that, with regard to foreign expenditure, they are largely in the hands of the mine manager, who, to a certain extent, might rob his employers with impunity, if he so chose.

For balance sheet purposes the mine manager should be required to apportion all expenditure between capital and revenue, and to certify such apportionment; also to submit a certified statement of

local current assets and liabilities, or a certificate that no such assets or liabilities exist locally, and at the same time he should report upon the state of efficiency of the plant and machinery, together with any buildings and other more or less permanent assets there may be upon the works. This latter report is most essential for a proper consideration of the question of depreciation.

It is always well—and where the produce of the mine is precious, it is essential—for the auditor to use every available means of ascertaining that credit has been taken in the books for the value of the whole of the output. In conclusion, it may be added that he should expressly state in his report the precise extent of his examination.

This is perhaps a convenient place to draw attention to the fact that in the case of undertakings having their principal scene of operations abroad, it is very usual, and most desirable, that a 'local' auditor should be employed to audit the foreign accounts. In the case of undertakings owned by individuals this circumstance gives rise to no complications. The local audit is a matter of contract between the parties, and the responsibilities of the local auditor are determined by the conditions of such contract, while the auditor at headquarters is as entitled to accept the report of the local auditors as the report of any other expert upon matters within his personal knowledge. In the case of companies, however, it is perhaps desirable to point out that, unless the local auditor is formally appointed by the shareholders as one of the auditors 'of the company'—which in point of fact is never done—his position is merely that of an employee of the company, and that his duty to the company is determined by the terms of his contract, and not by statute. In such circumstances the auditors of the company have as much right to accept the report of the local auditor as the report of the local manager, and they are entitled to accept it with less hesitation by reason of the fact that it is *prima facie* the report of an independent, rather than of an accounting, party. It is desirable, however, that in their report to the shareholders they should draw attention to the facts, in order that their responsibility may be limited accordingly. In the very unlikely event of the local auditor being formally appointed auditor of the company, the position would appear to be similar to that referred to under the heading of dual appointments in Chapter XII, which would be most unsatisfactory, in that presumably each auditor would be responsible for the work performed by the other, although for obvious reasons he would have had little or no opportunity of testing its efficiency. It not infrequently happens in such cases that the title deeds relating to the foreign property are abroad, and therefore cannot be produced for the inspection of the auditor at headquarters. In such cases it would seem to be part of the duty of the local auditor to inspect the title deeds, and to report that they are in order; but, however that may be, the facts of the case should be reported by the headquarters' auditor to the shareholders.

Questions of foreign exchange which must necessarily be raised where the property of British mining companies is abroad are dealt with in Chapter VII.

(b) **MINES UNDER THE STANNARIES ACTS.** It is not usual for the services of professional auditors to be requisitioned in these cases; but as the cost book system under which the Cornish mines are worked is one peculiarly suitable for mining accounts, and as, moreover, the system is not generally known in this country, it has been thought well to state briefly the outlines of its working. Auditors will find it may (so far as legally possible) be advantageously applied to the working of any metalliferous syndicate.

The owners of a mine are practically unlimited partners, with power to transfer their shares without the consent of their co-partners, or to withdraw altogether upon payment of their share of the current liabilities. No partner is liable for the mine's debts, after he has sold or relinquished his share in the mine.

The capital is unlimited. At the commencement it is usual to call up what is considered to be sufficient working capital for the next three months, and thereafter a general meeting must be called at least once in every sixteen weeks. At every meeting an account of receipts and payments and a detailed balance sheet must be submitted. If there be a surplus, the members are to decide whether the whole or any (and, if so, what) portion thereof shall be divided. If there be a deficit, a call should be made, sufficient to meet all outstanding liabilities and to provide further working capital for current needs.

There are two methods of paying the miners. 'Tributers' are placed on a definite pitch, and are paid a certain agreed proportion of the value of the metal raised by them. Contracts with tributers are renewed every eight weeks, and their earnings naturally vary very considerably. As they have to pay for candles, dynamite, fuses, tools, &c., they may even find themselves indebted to the mine at the end of their eight weeks' contract; on the other hand, their earnings are sometimes very high. The other method of payment is by 'stoping', under which the miner is paid so much per ton for all stuff (earth and ore) sent to the surface: under this arrangement a miner's earnings are much more regular.

IV. FINANCIAL ACCOUNTS. (a) BANKS. In dealing with the question of bank audits it is well to remember that one of the most controversial subjects relative to professional practice is being discussed. So far as possible, a position that few will care to assail will be occupied; but it is well to admit at once that the author considers the duties of a bank auditor to be very much more onerous than some other accountants admit, whatever the legal responsibilities may be. Further, it is to be remembered that the bare legal responsibility is not the highest measure of the duties of a professional man. It is certainly very desirable that the law should not be unduly harsh—or the position of an auditor would be intolerable—but it is imagined that few would consider that they had discharged all moral obligations as soon as they had complied with their statutory duties. These remarks, however, apply equally to all classes of audits.

Under the Companies Act, 1948 (Section 433 (1)—for which see Appendix A to this volume), limited banking companies are required

to exhibit a statement of their affairs. It is well, therefore, for the auditor to see that this section is complied with, and that the statement so exhibited is correct.

The audit of a bank balance sheet involves the thorough examination and exhaustive testing of every account in the general ledger, the counting of the balance of cash in hand, the examination of all bills (especial care being taken to note that all overdue bills are properly explained and that rebate of interest is duly allowed for at a uniform rate), and the inspection of all securities—in which latter task it is usual for the auditor to receive the advice and assistance of the solicitor. With regard to the counting of the cash balance, the only safe way of dealing with cheques in hand is for the auditor himself to forward them to the clearing house and other agents. The disregard of this precaution has left the door open for most serious frauds upon the part of bank managers and others. In connection with these matters, it is perhaps well to call attention to the extreme importance of *all* the cash and securities being produced simultaneously, and of their all remaining in the auditor's sole keeping until the inspection of all is completed. Extensive frauds have been known to remain undetected through failure to observe this simple precaution.

How far the auditor should extend his examination of the customers' accounts is a matter concerning which considerable difference of opinion exists; but many will endorse a statement long ago made that 'the overdrawn balances due from customers should be carefully scrutinised—more particularly those which are not secured or, being secured, have exceeded the limit fixed by the board of directors, and one important part of the auditor's duty, after making this examination, is to see that, in his judgment, ample provision has been made for the losses likely to arise upon them.'

Perhaps the chief difficulty in the audit of a large bank consists of the great number of its branches. Obviously it is of but little use for the auditor to check the cash balances at the various branches unless the checking is conducted simultaneously. By the proviso to subsection 2 of Section 134 of the Companies Act, 1929, the auditor was expressly relieved from any obligation to examine the accounts of any branch beyond the limits of Europe. In the words of this proviso, 'it shall be sufficient if the auditor is allowed access to such copies and extracts from such books and accounts of any such branch as have been transmitted to the head office of the company in Great Britain'. The proviso was repealed by the Companies Act, 1947, and is omitted from the Companies Act, 1948. The comment in the report of the Cohen Committee on company law amendment was that 'the proviso to Section 134 (2) appears archaic'. The duties of an auditor of a bank as regards branches are therefore determined by the second paragraph of the Ninth Schedule of the Companies Act, 1948, by which auditors must state in their report

'whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.'

A detailed audit extending to all the transactions of a bank is not practicable, nor—in view of the very highly developed system of

internal check employed—is it necessary. The branch managers and branch inspectors must perforce be relied upon to a very great extent, and in view of the evident improbability of successful collusion—it is thought that they may be safely depended upon. Here, as elsewhere, however, a knowledge of men and affairs is most valuable, and the auditor should not dismiss the possibility of dishonesty from his mind until he has reasonably satisfied himself upon the point. These remarks are in direct contradiction to the view expressed by the late Lord (then Mr.) Justice Vaughan Williams in the *New Oriental Bank* case, when he said: ‘It is not for an auditor to consider the bonafides of directors, but to deal with the books of the company and with commercial details and figures, not to consider the honesty of its officers.’ The views now expressed are believed, however, to be sound and practical.

It will be observed that the view adopted here with regard to a bank audit is that the verification of details may—and indeed must—to a large extent be left to the staff audit. The famous frauds upon the Bank of Liverpool, which paid upwards of £170,000 upon cheques forged by one of its ledger clerks, may perhaps raise a question as to whether this reliance upon the system of internal check is altogether justified in practice. It is thought, however, that the Liverpool frauds had little, if any, bearing upon the point, in that the system of internal check seems to have been chiefly conspicuous by its absence, or, at least, by its inefficiency. Three of the fundamental rules of any effective system are: (a) that no clerk should have access to books recording entries which act as a check on the entries made by that clerk; (b) that the clerks should be changed about at frequent intervals, so that a fraud—even if committed—may be speedily detected by a fresh clerk going over the same ground; (c) that no unusual entries, as for example, transfers, should ever be made without special authority. None of these fundamental precautions was adopted in the case mentioned, and it seems safe to say that, had any one of them been in force, the frauds could not have been committed, or would at least have been discovered at a very early date. Similarly, certain frauds at a rural branch of the Capital and Counties Bank were only possible because the same branch manager and cashier were left together for years. At the same time, as has already been stated elsewhere, it is always desirable that an auditor, when considering the exact extent of his investigation, should make careful inquiry into the system of internal check employed, and satisfy himself that the system theoretically in force is actually carried out in practice.

In dealing with bank accounts, and all other accounts of a similar nature, the auditor must never forget that his responsibilities are not confined to safeguarding the interests of the proprietors. His report carries great weight with the public. It is not, of course, suggested that he guarantees the safety of the customers’ deposits; but he would reasonably be blamed if, after he had signed without remark the usual auditor’s report on an apparently sound balance sheet, the bank were afterwards discovered to be insolvent.

At first sight it may appear impossible for the auditor to act up to

the position here indicated, but he must remember that, in reality, the test of an auditor's competency is his ability to judge the correctness of items by an exhaustive testing—not necessarily of the items themselves, but of their totals. It need hardly be added, however, that a knowledge of banking theory and practice will be found an all but essential aid for this purpose. This may perhaps be thought to imply that a half-yearly audit would be sufficient; but the author considers that a bank audit—to be really effective—should be continuous, for it is extremely difficult for the auditor who is not frequently on the spot to get insight into the manner in which the business is carried on.

A few remarks concerning the revenue account of a bank will not be out of place. The items of interest constituting the gross profit must be carefully tested, especially as to the rate charged upon current transactions. Where credit is taken for interest on doubtful advances it will require the most careful consideration. With regard to the rebate upon bills in hand, it has already been stated that this should be at a uniform rate; by this, however, is not meant that the rate must necessarily be a fixed one. Some banks employ a fixed rate (generally 5 per cent.), while some employ the rate actually charged in each case; and some, again, the current market rate. The first and third methods possess the merit of simplicity, but perhaps the second is the most strictly accurate. The great thing for the auditor to observe, however, is that one method is uniformly adopted, otherwise the profits of the year might easily be manipulated.

In the case of the audit of a bank, it is not easy to see how any practicable system can infallibly detect fraud at once. If a dishonest general manager makes loans to his friends, and shares the proceeds with them, the probability is that there will be nothing to arouse the auditor's suspicions until the loan (or the interest thereon) becomes overdue. This is practically the same form of fraud as that perpetrated in the *National Bank of Wales* case: with care, one loan can be paid off out of the proceeds of a new one, and so on *ad infinitum*—almost! An auditor can hardly be expected always to discover a fraud of this kind: the proper safeguard is an efficient board of directors that does not leave everything to the general manager. In the later case of *Farrow's Bank* no complicated question of audit arose. The directors were convicted of fraudulently writing up assets in order to show large profits that had no existence in fact. The auditor (who, by the way, was also the 'accountant' of the bank, and not a Chartered Accountant) was convicted of participation in this fraud.

Banking companies are exempt from many of the requirements of the Companies Act, 1948, in regard to the form and content of the profit and loss account and balance sheet. (See Chapter VIII).

(b) **INSURANCE OFFICES.** All persons or bodies of persons, whether corporate or incorporate (save friendly societies and trade unions) who carry on assurance business as defined in the Act are subject to the provisions of the Assurance Companies Act, 1909, as amended by the Assurance Companies Act, 1946 (*vide* Appendix A), the contents of which should be studied carefully. One of the main

points of the Act is contained in Section 3 which requires that receipts relating to each class of business carried on shall be carried to a separate fund, but while the funds (regarded as credit balances) are thus separately built up there is no requirement for separate investment of those funds. Consequently the investment income when received will have to be apportioned over the funds in proportion to the average annual amount of each fund. Expenses, where not 'direct', are apportioned on a basis which reasonably accords with the facts.

By Section 2 of the Assurance Companies Act, 1909, every assurance company was required to deposit the sum of £20,000 with the Paymaster-General. By Section 4 of the Assurance Companies Act, 1946, such a deposit is no longer necessary. On the other hand, Section 2 of the Act of 1946 provides that any new undertaking which on or after 29th October, 1945, commences to carry on assurance business of a class to which the principal Act applies, must be an incorporated company having a paid-up share capital of not less than £50,000. In addition, under Section 3 of the Act of 1946, an assurance company shall be deemed to be unable to pay its debts (and may thus become liable to be wound up) unless the value of its assets exceeds the amount of its liabilities by either (a) £50,000, or (b) one-tenth of its general premium income in the last preceding financial year, whichever is the greater.

Under the Act of 1909, the balance sheet must itself state how the value of stock exchange securities is arrived at, and a certificate must be appended, signed by the same persons as sign the balance sheet (i.e. not by the auditor) 'to the effect that in their belief the assets set forth in the balance sheet are in the aggregate fully of the value stated therein, less any investment reserve fund taken into account'. In the case of life business or bond investment business, this certificate is required only when a statement respecting valuation is made. By regulations made in connection with Section 3 of the Act of 1946, the balance sheet must include a certificate signed by the persons who sign the balance sheet to the effect that the value of the assets exceeds the amount of the liabilities by the required amount. In the case of companies carrying on life assurance or bond investment business there are two further requirements:

1. The certificate must include a statement to the effect that the liabilities in respect of long-term business have been taken at the amounts of the respective funds and all other liabilities in respect of long-term business as shown in the balance sheet.
2. The balance sheet must also include a certificate signed by the actuary to the effect that in his belief the liabilities in respect of long-term business do not exceed the amounts of the respective funds and all other liabilities in respect of long-term business as shown in the balance sheet.

Withdrawal of deposits under Section 4 of the Act of 1946 is subject to certain conditions. In the case of a company carrying on general business with or without life assurance or bond investment business, the Board of Trade must be satisfied that the value of the company's

assets exceeds its liabilities by the amount required by Section 3 of that act (see above). In the case of a company carrying on long-term business only, the Board of Trade must be satisfied that the paid-up share capital exceeds £50,000 or that its assets exceed its liabilities by at least £50,000. An application for a withdrawal of a deposit must be accompanied by a certificate or certificates relating to the above conditions. It is also provided that the Board of Trade may require these certificates to be supported by accounts or statements certified by an auditor to be approved by the Board.

Where the company is required to keep separate funds under Section 3 a certificate must be appended, signed by the same persons as sign the balance sheet, *and by the auditor*, 'to the effect that no part of any such fund has been applied, directly or indirectly, for any purpose other than the class of business to which it is applicable'.

It will be convenient to deal first with fire offices, and afterwards to consider the various modifications necessary for the audit of other insurance accounts.

FIRE OFFICES. The first point for the auditor is to satisfy himself as to the total amount of income receivable. The policy book and the renewal register—modified by the 'specials' and endorsement books—will provide him with this information; but a large amount of tedious (although most necessary) checking of additions must be done before the result is finally arrived at. Where renewal receipts are written out for *all* existing policies, the production of all unused receipts should be required as a voucher for policies discontinued; but where blank receipts are used—either in the head office, or at the branches or agencies—the number of receipts issued, used, and returned must be compared with the number of renewals and discontinuances, allowance being made for such receipts as have been spoiled.

It is not necessary for the premium income to be checked in detail; the gross amount receivable is known, and the insurances discontinued can be verified, the net amount receivable can thus be arrived at. The total cash received on account of premiums, less the outstanding balances at the commencement of the period, should agree with the net amount receivable, less the balances outstanding at the close of the books. A list of these latter will be furnished to the auditor, which he can easily check by satisfying himself that they have either been actually received since the closing of the books, or have been acknowledged by the agents to have been received by them. This is a much smaller affair than checking each item received, but it is equally effective and affords a helpful bird's-eye view of the effect of all the transactions taken together.

Reinsurances will, of course, require due examination, but they call for no special comment.

The cash book must be carefully added and agreed with the banker's pass books. It is well to follow the counterfoil receipts for all miscellaneous receipts into the cash book in detail. It is not usually a very long job, and these items cannot well be verified in any other way.

Income from investments can be vouched by comparing the items with the 'tops' of the dividend warrants. The fact that all the items

are duly brought in can be established by checking the postings to the income column of the investment ledger or register and by inquiring into any blanks thereby disclosed.

With regard to losses, it is not usual—unless the amount is large—to go behind the voucher for the receipt of the amount paid; the directors who signed the cheques must be presumed to have satisfied themselves (and to have undertaken the responsibility) concerning the bona fides of the claims allowed. The postings of the cash book should, however, all be checked. It is well, however, to call for the claims book, with a view to making sure that due provision has been made among the liabilities for all claims received in respect of losses incurred up to the date of balancing.

Agents' commission can be vouched by reference to the actual receipts given by them and the amounts brought in as 'agents' balances' should be tested by reference to the accounts rendered by the agents. These accounts must all be signed by the several agents responsible. The remaining expenses can be vouched in the usual manner and no special points arise.

The valuation of the balance sheet assets is more appropriately considered in a later chapter, while the method of verifying the items is similar to that obtaining under banks and kindred associations.

UNEXPIRED RISKS. The percentage of premium income to be carried forward as a provision against unexpired risks must not be lost sight of. From 30 to 33 per cent. is perhaps the usual minimum allowance. If a smaller amount be reserved, the effect is that the company is not setting aside a sum that would be sufficient to enable it to reinsure against the whole of its liabilities under current policies. It should be added that the premiums due at Christmas are *not* included in the accounts drawn up at the close of the year.

Another similar item that must not be forgotten is that of premiums paid in advance. Where a reduced premium is accepted for, say, seven years' premiums paid in advance, the question of interest ought really to be considered; but as these transactions are generally not very numerous, interest is not usually provided for.

The item 'premium income' should always be stated 'less re-insurances', both for the sake of showing the net revenue of the company and for calculating the provision for unexpired risks.

The accumulated reserves of a sound company should always amount to at least one year's net premium income—in some of the best offices they run as high as two years' income or more.

LIFE OFFICES are governed—so far as the form of their accounts is concerned, and in many other respects of less immediate interest to the auditor—by the Assurance Companies Act, 1909. The material portions of this Act are included in Appendix A, and should, of course, be thoroughly mastered by the auditor before commencing his work. The remarks which preceded the above consideration of fire offices will also affect life offices.

Every five years (or at such shorter periods as may be required by the constitution of the company) a 'valuation' balance sheet will have to be prepared. The distinguishing feature of these periodical

accounts is, of course, the actuarial valuation of the office's liability to the policy-holders. The auditor is not responsible for the accuracy of this valuation, but it is his duty to see that the accounts are duly prepared in accordance with the actuary's figures.

For the benefit of the reader who has had no acquaintance with life insurance accounts, it may be stated that the usual balance sheet and accounts are purely *interim* accounts, and that it is only when the periodical 'valuation' takes place that the true profit is ascertained. It will be apparent that the mere excess of premium and other income over claims and other expenses is not profit; for life assurance contracts do not ordinarily come to an end at the end of each year. The office is under a continuing liability which will mature when the life assured falls in. The agreed premium is to be paid throughout life, or other period of assurance. Now that premium is certainly not the one which would be charged for *one year's* assurance either at the beginning or at the end of the life assured. When the life is young the premium for one year would be less and when it is old the premium would be greater. Consequently the true profit can be measured only after a portion of the earlier premiums has been set aside to accumulate and to answer the natural deficiency of the actual premiums of later years. In the books, in the periods between actuarial valuations, the excess of premiums and other income over claims and expenses is carried forward as the life assurance fund but the true amount required to be held to answer future claims can be determined only by actuarial investigation. The process is, in outline, as follows: the present value, i.e. the discounted value taking a low rate of interest, of the future capital claims is calculated and from this is deducted the similar present value of that portion of the future premiums which does not represent expenses; the result gives the amount which should now be held to accumulate for the purpose of answering future claims as they mature. If the fund, as shown by the books, exceeds this, the difference is profit which may be taken out of the fund so as to leave the latter at the figure calculated to be sufficient. It will be realised that where mutual offices share out this profit, either in cash or in the form of a reversionary addition to policies, such cash payments are, in effect, a deduction from the fund while those profits added to policies attract no entries in the financial books since the result of the arrangement is to increase the actuarial liability of the office and consequently a correspondingly increased fund is required to meet it. A careful perusal of the statutory form of accounts appearing in Appendix A will readily enable the reader to follow the matters we have tried to explain.

The routine of the audit will differ but little from that of a fire officer, but the auditor will be wise to pay particular attention to the surrenders. Claims should also be more carefully looked to than is necessary in fire offices.

The audit of the investments will be a much more voluminous matter than before, because a life office is really a professional investor of a pool of small savings and all the first-class offices have now accumulated enormous invested funds. In principle, however,

the matter does not differ from the case of fire offices which has already been dealt with.

In some cases the auditor of a life office will have been appointed especially to protect the interest of policy-holders. In every case, however, the auditor should consider himself responsible to the policy-holders for the correctness of the accounts, which he should on no account unqualifiedly certify, unless he is convinced of the stability of the undertaking.

ACCIDENT, GUARANTEE, AND OTHER OFFICES do not raise any new considerations. The great majority of such accounts follow entirely upon the lines of fire offices—the company's contract being an annual one, which it can discontinue at the running off of any policy, should it think well to do so. The Business of SICKNESS ASSURANCE, however, more nearly approaches that of a life office, and actuarial assistance will be required for the determination of the value of the unexpired risks. No special legislation has been enacted relative to sickness assurance offices.

Annual Accounts and Balance Sheet. Every assurance company to which the Assurance Companies Act, 1909, applies, is bound to prepare annually a revenue account, a profit and loss account, and a balance sheet, in the forms prescribed in the First, Second and Third Schedules to that Act. These accounts and balance sheet must be deposited with the Board of Trade (*see Appendix A*).

Most assurance companies are registered under the Companies Acts, and therefore present to their shareholders accounts which conform with the requirements of the Companies Act, 1948. These accounts are not, of course, completely identical in form with those deposited with the Board of Trade. An assurance company which has deposited with the Board of Trade accounts which conform with the requirements of the Assurance Companies Act, 1909, and which has sent a copy of those accounts to the Registrar of Companies, is not obliged to annex to its annual return a copy of the accounts drawn up in accordance with the Companies Act, 1948. (Section 7 (4), Assurance Companies Act, 1909, and Section 127 (4), Companies Act, 1948.)

By Section 435 of the Companies Act, 1948, and regulations made thereunder, the provisions of the Companies Act as to accounts and audit are applied to certain unregistered companies.

By Rule 12 of the Assurance Companies Rules, 1950, the accounts of an assurance company which is not subject to the audit provisions of the Companies Clauses Consolidation Act, 1845, or the Companies Act, 1948, are to be audited in accordance with the provisions of Sections 161 and 162 of the Companies Act, 1948.

The effect of the decision in the important case of *Re City Equitable Fire Insurance Co. Ltd.*, is dealt with later in this work.

(c) TRUST AND INVESTMENT COMPANIES. The accounts of these companies, regarded as pieces of book-keeping, are, probably, as simple as accounts can well be. The ostensible purpose of such companies is to enable investors to spread their capital over a large,

field, and so by the principle of average, to obtain a better security for their principal without a corresponding sacrifice of income.

How far the trust companies of the day have acted up to this theory of their existence it is beyond the present purpose to inquire. Suffice it to say that, from the shareholder's point of view, the only satisfactory accounts will be those which indicate a fair rate of income earned without depreciation of capital.

In the case of these companies examination of the memorandum of association is especially important in order that the auditor may see that the directors have kept the investments within the limits comprised by the company's powers. The articles, too, may contain provisions as to the valuation of the securities in the balance sheet and as to such matters as the treatment of profits and losses on realisation.

The auditor will require to see brokers' contract notes for all sales and purchases, and also to ascertain that all dividends and interest have been properly accounted for. Purchases cum div. and sales ex div. will probably be the most likely cases in which an irregularity may occur. Only income earned during the time that an investment is held should be credited to revenue, while revenue is entitled to due credit for *all* income earned during that period.

There can be no question that from the purely accounting point of view the first dividend received after the purchase of an investment should be apportioned so as to restore to capital that portion thereof which relates to the period prior to the date of purchase. Similarly, in the case of a purchase ex div., it is correct to add to the cost of the investment and to revenue a sum equal to the net dividend attributable to the period between date of purchase and the commencement of the next dividend period, though for obvious reasons this last refinement is sometimes omitted. When an investment is sold similar considerations apply in the reverse direction. If the sale is cum div. it is clear that the price received includes a quantum of income and that amount, calculated from the commencement of the current dividend period to date of sale, must be credited to revenue. If the sale is ex div. the market will have deducted from the price a full period's dividend at the moment when the quotation changed from cum div. and accordingly in strictness, capital should further receive, at the expense of revenue, the portion of dividend which relates to the period from date of sale to the commencement of the next dividend period. It will be remembered that in the last-named case a dividend for a full period will be received after the investment has been transferred and it is out of this that the addition to the proceeds of sale can be made.

It must be added that special cases sometimes operate to modify the strict theory of apportionment which has been outlined above.

The valuation of investments is perhaps the most important function of the audit of trust companies. The Companies Act, 1948, requires the disclosure, in the balance sheet, by way of a note or in a statement or report annexed, of the aggregate market value of a company's quoted investments other than trade investments, if such value differs from the amount at which the investments appear in the balance sheet. This requirement is not, of course, confined to trust and

investment companies. As regards companies of this class, the Act merely makes compulsory what was already the usual practice.

It is not always imperative that investments should be written down in the books to market price. In the first place, the principle of averages may consistently be followed here, and it will suffice if the aggregate market price be not less than the aggregate book price. If, however, there be a deficiency in this respect, it should be met, if at all, not by a revision of individual values, but by a setting aside of a lump sum to an investment fluctuation account as a provision against loss. This provision may be deducted from the amount of investments in the balance sheet.

When the aggregate market value exceeds the aggregate cost price it is usual to retain the investments at cost price.

With regard to the profits or losses arising from sales made during the period under audit, due regard should be paid to the remark, already made on the subject of apportionment. Such profits and losses made during any one year should be treated in the aggregate: if the result be a profit, it is available for dividend though it is highly desirable that profits made by changes of investments be taken to reserve, and not credited to revenue. If a loss be the result, it should come out of revenue, unless an adequate reserve exists from which the loss may be taken. It has been decided by the Court of Appeal in the case of *Verner v. General and Commercial Investment Trust* that a 'pure' trust company may, by its articles of association, provide that all sums received as interest or dividends upon investments (less administration expenses) are profits available for dividend, without taking into consideration any depreciation or loss arising from fluctuation in the value of the capital assets of the company. The judgment of the Court of Appeal will be found duly recorded in Appendix B; it may, however, be added that the view taken by the Court seems to be that it is quite competent for a company so to constitute itself that its members are, for all practical purposes, in the same position as life-tenants would be in the case of an ordinary trust; that is to say, they are to receive whatever income is earned (less current expenses), without any reduction in respect of losses of capital or any accretion in respect of gains. Of course, in the case of an ordinary trust the field of investment is expressly limited to first-class securities unless the instrument creating the trust enlarges it: in the case of a trust company the instrument creating the trust is the memorandum of association, and if sufficiently wide powers be contained in the memorandum, it seems to be possible for the company to invest in the most speculative concerns without making any provision for possible or ascertained losses, so long as creditors are not defrauded thereby.

A note of caution must be addressed to the reader of the *Verner* case. The decision has reference to the question of the declaration of a dividend and to that alone. It has no reference to the questions arising from the balance sheet disclosure of the facts and it certainly does not justify concealing from the members the fact that there has been a fall in the market value of the company's investments. 'Further,' said Lord Justice Lindley, 'it is obvious that capital lost must not

appear in the accounts as still existing intact; the accounts must show the truth and not be misleading or fraudulent.' It has already been pointed out that the Companies Act, 1948, requires the disclosure of the market value of investments.

In Appendix B will be found a report of the late Mr. (afterwards Lord) Justice Stirling's judgment in the case of *Wilmer v. McNamara & Co. Ltd.*, which is founded upon the decision just stated, but further extends it, for the Court declined to interfere in the distribution of a dividend declared in the case of a trading company, notwithstanding the fact that it was not satisfied that a sufficient sum had been set aside to meet the depreciation that had actually occurred in the wasting assets. The truth of the position seems to be that in this case—and, for that matter, many other similar cases—the attitude taken up by the Courts has been that they cannot undertake to act 'as a providence' to all and sundry. The directors are presumed to be men of business ability and so long as there is no evidence of bad faith only very strong reasons will induce the Courts to interfere with the discretion of the board. So long as creditors are not defrauded, and so long as persons are not induced to take shares by misrepresentation, the Courts leave each separate company to carry on its own business on the lines decided by its directors, within the provisions of its articles.

(d) UNIT TRUSTS. The rapid growth of the unit trust movement has been one of the most remarkable financial developments of recent years. The unit trust, like the investment trust company, is founded upon the principle of enabling the investor to spread his capital over a number of investments, with a corresponding reduction of risk. The structure of the unit trust is, however, very different from that of the investment trust company. The investments are purchased by a management company and are deposited with a trustee in accordance with the provisions of a trust deed, which provides for the acquisition of specified securities in stated proportions. The trustee is usually a bank or insurance company. The securities, which are registered in the name of the trustee, are divided into a number of units and sub-units, and these are sold to investors, at a price which includes a margin for expenses. The capital of the investor is thus represented by a proportion of each of the securities which the trustees hold. The income from the securities is collected by the trustees and distributed to the unit-holders. The management company will repurchase units from unit-holders who wish to dispose of their holdings.

A distinction must be drawn between fixed and flexible trusts. In the case of the former, the trust deed permits little or no variation in the investments, but, the managers of the latter type of trust have power, within strictly defined limits, to vary the investments.

It is claimed for the unit trust system that the investor can spread his risk over a wide field, and also knows exactly what investments his holding represents. On the other hand, the position of unit-holders is very different from that of shareholders. While shareholders, by their votes, can exercise some control over a company and its directors, unit-holders have no control over the managers of a trust, and lack

the protection which the Companies Act gives to the shareholders of a company. The dangers latent in the system were quickly recognised and, after some lapse of time, certain measures of control were introduced. By the Prevention of Fraud (Investments) Act, 1939, dealings in securities were made subject to severe restrictions, and unit trusts were to be exempt only if individually declared by the Board of Trade to be 'authorised unit-trust schemes'. Authorisation is subject to certain conditions which are set out in Section 16 of this Act and in the Schedule to the Act. The Schedule has been amended by Section 117 of the Companies Act, 1947*. By Section 16, the manager and trustee must be corporations incorporated under the law of some part of the United Kingdom, and the trustee corporation must satisfy certain minimum requirements as to issued capital. The control of the management corporation must be independent of the trustee corporation. The Schedule to the Prevention of Fraud (Investments) Act, 1939, and Section 117 of the Companies Act, 1947, lay down, in general terms, certain conditions with which trust deeds must comply. The Board of Trade is empowered to make regulations requiring that trust deeds shall include such provisions as the Board prescribes for the fulfilment of these conditions. The Prevention of Fraud (Investments) Act came into force in August, 1944, and in the same month the Board of Trade issued regulations prescribing compulsory provisions to be incorporated in trust deeds. The regulations include provisions relating to accounts and audit, in the following terms:

AUDIT

The trust deed should provide for audit by accountants approved by the trustee of all accounts before circularisation and for a certificate of audit to be appended to the accounts circulated. The audit certificate should declare that the accounts and statements attached thereto have been examined with the books and records of the trust and of the management company, in relation thereto, and that the auditors have obtained all the information and explanation they have required. The auditors should report whether the accounts are, in their opinion, properly drawn up in accordance with such books and records to disclose the profits or losses accruing to the managers from the trust.

ACCOUNTS

The trust deed should provide for the circulation to unit holders, not less frequently than once a year (but not more than six months after the end of the period to which they relate), of accounts which contain *as a minimum* the information shown in the individual items in Appendix A and Appendix B.

Attached to these accounts there must be a statement certified by the auditor showing the amount and percentage gross profits (before any deductions) or losses made (1) from the sale of new units; (2) from the resale of units; and (3) from the sale of underlying securities of liquidated units.

If in the aggregate the holding of securities before appropriation or after liquidation of units and the holding of units results in a loss the manager shall disclose such loss in each of the above statements. The manager may disclose any holding profit if he so desires.

The percentage profit or loss from the sale of new units should be calculated on the proceeds in the period of the account of the sale of new units. The percentage profit or loss from the resale of units should be calculated on the proceeds in the period of the account of the resale of units, and the percentage profit or loss from the sale of underlying securities of liquidated units should be calculated

* This section was not repealed by the Companies Act, 1948, and therefore remains in force.

on the proceeds in the period of the account of such sales. (The cost of the securities to the manager should be regarded as the price allowed in the purchase of the relevant unit.)

Note.—Holding profits or losses shall be deemed to be profits or losses resulting from price variations of (a) units between the dates of creation or purchase and sale; (b) underlying securities between the time of purchase and appropriation and between the time of liquidation of units and sale of the underlying securities.

CAPITAL AND INCOME DISTRIBUTIONS

The trust deed should also provide that as at the end of each distribution period there should be circulated two statements certified by the auditors. The first should show what percentage of the total value of the trust funds was at the end of the distribution period invested in each investment and the percentage represented by cash (other than cash to be distributed for that period), and appended to these statements there should be quoted the bid price of units (ex dividend) on the last day of the distribution period.

The second statement should show how the amounts distributed to unit holders are made up, setting out in respect of each distribution and related to some convenient number of units, the gross amount of all cash dividends, interest, income bonuses, &c., the amount of income-tax deducted therefrom, the amount of any cash of a capital nature which is distributed and its source and the amount of all deductions, whether by way of annual or semi-annual charge from income or capital, together with an indication of the provisions in the trust deed which authorise such deductions and state separately the amount included in respect of any dividends accrued before the purchase or vesting of the relevant securities. The statement in respect of capital distributions should be kept distinct from that in respect of income distributions.

DIRECTORS' CERTIFICATE

The trust deed should provide that the accounts shall be accompanied by a certificate signed by the directors of the management company, stating whether the company has or has not:

- (i) transferred units to another person for sale, resale, liquidation, or subsequent transfer to the management company, for sale, resale or liquidation; or
- (ii) acquired or disposed of underlying securities otherwise than through recognised Stock Exchange, or
- (iii) disposed of units to another person for a price lower than the current offered price; or
- (iv) acquired units for a price higher than the current bid price, and if so, to what extent in each case.

The directors may append any explanation they deem desirable.

The rule for requiring the managers (subject to any provisions as to appeal, contained in the deed) to retire from the trust if the trust deed certifies that it is in the interests of the beneficiaries under the trust that he should do so is as follows:

It would be sufficient if a trust deed contained a clause reproducing the substance of this paragraph.

By Sections 53-55 of the Finance Act, 1946, stamp duty is imposed on trust instruments of unit trusts and on transfers of units. By Section 56 (3), the Commissioners of Inland Revenue may make regulations requiring trustees and managers of unit trusts to keep records and registers relating to units and unit-holders. The regulations at present in force are known as the Unit Trust Records Regulations, 1946. Section 16 of the Prevention of Fraud (Investments) Act, 1939, the Schedule to that Act, Section 117 of the Companies Act, 1947, and the Unit Trust Records Regulations, 1946, are reproduced in Appendix A.

(e) **FINANCE COMPANIES.** It is important to distinguish between trust (or investment) companies and speculative finance companies. The chief profits of the former are income derived from investments while profits derived from a change of investments arise only incidentally. On the other hand profits derived from a change of investments form the main source of income of finance companies; consequently all such investments must be regarded as so much stock-in-trade—as current assets—and must be valued accordingly, whereas the investments of a trust company may fairly be treated as fixed assets. The difficulty of this distinction lies in the fact that whereas the investments of a speculative finance company ought never to be valued at a price in excess of the current market price, it is frequently difficult (if not impossible) to arrive at any reliable basis of valuation; for Stock Exchange quotations are by no means necessarily a reliable basis, if there be no free market. Again, it may be pointed out that, following the ordinary principles of the valuation of unsold stock, no appreciation in the value of investments ought to be credited to revenue until those investments have actually been sold. It is not, however, necessary to write down each separate investment that has depreciated; the proper course would appear to be to maintain the investments in the balance sheet at cost price, making provision sufficient to cover any deficiency in the aggregate intrinsic value, as contrasted with the aggregate book value. Realised profits may, of course, properly be credited to revenue; but care should be taken to see that they have been actually realised in cash, and, so far as possible, the auditor should be upon his guard against the inflation of profits by means of 'accommodation' transactions between different members of a group of companies. In these days of amalgamations and working arrangements some such warning as this seems especially necessary.

To sum up, it appears that although in some circumstances dividends may legally be declared out of current revenue without first making good depreciation of investments, it is, on the other hand, certain that the declaration of such dividends is a direct violation of every principle of sound finance, and should at all times be discouraged by the auditor, who should make sure that the true position of affairs is sufficiently revealed to the shareholders, either upon the face of the accounts, or by a special clause included in his report.

CHAPTER V

SPECIAL CONSIDERATIONS IN DIFFERENT CLASSES OF AUDITS

(Continued)

V. THE NATIONALISED INDUSTRIES. (a) THE NATIONAL COAL BOARD. By the provisions of the Coal Industry Nationalisation Act, 1946, the coal mining industry was transferred to public ownership, and the National Coal Board was set up for this purpose. Provisions for accounts and audit are contained in Section 31 of the Act, as follows:

(1) The Board shall keep proper accounts and other records in relation thereto, and shall prepare in respect of each financial year of the Board a statement of accounts in such form as the Minister may direct, being a form which shall conform with the best commercial standards and which shall distinguish the colliery activities and each of the main ancillary activities of the Board.

(2) The accounts of the Board shall be audited by auditors to be appointed annually by the Minister.

(3) So soon as the accounts of the Board have been audited, they shall send a copy of the statement of accounts referred to in subsection (1) of this section to the Minister, together with a copy of any report made by the auditors on that statement or on the accounts of the Board.

(4) The Minister shall lay a copy of every such statement and report before each House of Parliament.

It was expected that nationalisation would lead to a concentration of audit work. This development is particularly marked in the case of the National Coal Board; a single firm has been appointed by the Minister of Fuel and Power to act as auditors. On the other hand, the Board has organised an internal audit department, to which reference is made in the following paragraphs of the annual report of the Board for 1947:

445. In recent years a number of large business organisations have adopted what is known as 'internal audit', that is, they have a staff of experienced auditors who carry out detailed checking in collaboration with outside auditors. Some of the largest concerns in the coal industry had internal audit staffs who were mainly engaged on the checking of wages.

446. It would be necessary in any case to develop a staff to review systems of internal check and to test the efficiency of accounting and other techniques and this work can most conveniently be associated with audit work. Moreover the detailed checking involved in audit can be carried out more economically by an internal audit staff than by outside auditors.

447. The Board accordingly decided to organise an internal audit staff. The whole of the arrangements were settled in conjunction with the outside auditors and approved by them. The programmes of internal audit were settled in consultation with the outside auditors and all reports and working papers of the internal auditors were available to them. The outside auditors verify that the internal auditors are in fact carrying out an effective check.

448. A small internal audit staff is attached to each area, under the control of an area internal auditor, who, although attached to the staff of the area chief accountant, reports direct to the divisional chief internal auditor and thus has the

necessary measure of independence. Similarly, the divisional chief internal auditor has the right to report direct to the Board's chief internal auditor at headquarters, who in turn has the right to report direct to the Board.

449. The nucleus of the internal audit staff was found from those already engaged in this work in the coal industry. New appointments have been made from the staffs of firms of accountants, mainly those with large practices in the coal industry, and from other staffs with extensive experience of coal industry accounts. On 31st December, 1947, there were 198 internal auditors in the coal industry, of whom 51 held professional qualifications.

Directions as to the form and content of the annual accounts were issued by the Ministry of Fuel and Power in June, 1948, and are reproduced in Appendix A. The prescribed form of accounts follows the modern trend in methods of presentation. It is to be observed that Section 31 of the Act imposes 'conformity with the best commercial standards'.

Section 1 (4) (c) of the Coal Industry Nationalisation Act provides that 'the revenues of the Board shall not be less than sufficient for meeting all their outgoings properly chargeable to revenue account . . . on an average of good and bad years'.

(b) THE GAS COUNCIL AND AREA BOARDS. The gas industry was brought under public ownership by the Gas Act, 1948. A Gas Council has been set up, and the manufacture and supply of gas has been taken over by twelve area boards.

Section 50 of the Act provides that:

(1) Each area board and the Gas Council shall keep proper accounts and other records in relation to the business of that Board or Council, as the case may be, and shall prepare in respect of each financial year a statement of accounts in such form as the Minister, with the approval of the Treasury, may direct, being a form which shall conform with the best commercial standards.

(2) The form of the said statement shall be such as to secure the provision of separate information as respects each of the main activities of the board concerned or of the council, and to show as far as may be the financial and operating results of each such activity.

(3) The accounts of every area board and the Gas Council shall be audited by auditors to be appointed in respect of each financial year by the Minister:

Provided that no person shall be qualified to be so appointed unless he is a member of one or more of the following bodies:

The Institute of Chartered Accountants in England and Wales;

The Society of Incorporated Accountants and Auditors;

The Society of Accountants in Edinburgh;*

The Institute of Accountants and Actuaries in Glasgow;*

The Society of Accountants in Aberdeen;*

The Association of Certified and Corporate Accountants;

The Institute of Chartered Accountants in Ireland.

(4) Every area board and the Gas Council shall as soon as their accounts have been audited, send a copy of the statement thereof referred to in subsection (1) of this section to the Minister together with a copy of any report made by the auditors on that statement or on those accounts, and copies of those statements and of every such report shall be made available to the public at a reasonable price.

(5) The Minister shall lay a copy of every such statement and report before each House of Parliament.

Since the accounts must conform with the best commercial standards, it may be expected that there will be no reproduction of the distinctive

*Now amalgamated as the Institute of Chartered Accountants of Scotland.

features of the double account system. It may also be expected that the accounts of the various area boards will be prepared on a uniform basis, and that there will be a general co-ordination of accounting and costing systems. The requirement that auditors under the Gas Act must possess a recognised professional qualification is a step which has been welcomed by the profession.

The concentration of audit work is less marked than in the case of the coal industry, since the existence of twelve separate area boards has led to a wider distribution.

Section 41 of the Act imposes on each area board the duty of securing that its revenues are sufficient to meet the outgoings properly chargeable to revenue account, taking one year with another.

Section 49 of the Act provides that the amounts properly chargeable to revenue are to include allocations to a central guarantee fund and general reserve fund, provision for redemption of capital and provision for depreciation or renewal of assets.

The principle adopted in relation to gas and, as will be shown below, other nationalised public utility undertakings, is that the price of the service to the consumer is to be fixed at a level sufficiently high to cover not only the cost of the service, including depreciation of capital equipment, but also redemption of capital.

(c) **THE BRITISH ELECTRICITY AUTHORITY AND AREA BOARDS.** The electricity supply industry was nationalised by the Electricity Act, 1947. Under this Act, the British Electricity Authority (known as the Central Authority) and fourteen area boards were set up. Provisions for accounts and audit are contained in Section 46 of the Act, which is reproduced below. It will be seen that it is very similar in terms to the corresponding section of the Gas Act, 1948.

Section 46—

(1) The central authority and each area board shall keep proper accounts and other records in relation to the business of that authority or the business of that board, as the case may be, and shall prepare in respect of each financial year a statement of accounts in such form as the Minister, with the approval of the Treasury, may direct, being a form which shall conform with the best commercial standards.

(2) The form of the said statement shall be such as to secure the provision of separate information as respects the generation of electricity, the distribution of electricity, and each of the main other activities of the electricity board concerned, and to show as far as may be the financial and operating results of each such activity.

(3) The accounts of the central authority and of every area board shall be audited by auditors to be appointed in respect of each financial year by the Minister:

Provided that no person shall be qualified to be so appointed unless he is a member of one or more of the following bodies:

- The Institute of Chartered Accountants in England and Wales;
- The Society of Incorporated Accountants and Auditors;
- The Society of Accountants in Edinburgh;*
- The Institute of Accountants and Actuaries in Glasgow;*
- The Society of Accountants in Aberdeen;*
- The Association of Certified and Corporate Accountants.

*Now amalgamated as the Institute of Chartered Accountants of Scotland.

(4) So soon as the accounts of any area board have been audited, they shall send the statement of their accounts referred to in subsection (1) of this section to the central authority together with a copy of any report made by the auditors on that statement or on the accounts of the board.

(5) So soon as the accounts of the central authority have been audited they shall send a copy of the statement of their accounts referred to in subsection (1) of this section to the Minister together with a copy of any report made by the auditors on that statement or on the accounts of the authority and shall also send copies of the statements of accounts of every area board to the Minister, together with any reports on those statements or accounts as aforesaid, and copies thereof shall be made available to the public at a reasonable price.

(6) The Minister shall lay a copy of every such statement and report before each House of Parliament.

Section 36 (1) of the Act provides as follows:

It shall be the duty of the central authority so to exercise and perform their functions under this Act, including their functions in relation to area boards, as to secure that the combined revenues of the central authority and all the area boards taken together are not less than sufficient to meet their combined outgoings properly chargeable to revenue account taking one year with another.

It may be observed that while, in the case of electricity, the revenue and outgoings of the several bodies are, under the above provision, taken together, Section 41 of the Gas Act requires that *each* gas area board shall secure that its revenues are sufficient to meet outgoings.

Section 45 provides that the amounts properly chargeable to revenue include allocations to a central reserve fund, provision for redemption of capital and provision for depreciation or renewal of assets.

(d) **THE BRITISH TRANSPORT COMMISSION.** The British Transport Commission was set up under the provisions of the Transport Act, 1947. The major part of the transport system of the country, including railways, canals, the London passenger transport system, and certain other undertakings, was transferred to this body, with effect from 1st January, 1948.

Section 94 of the Transport Act provides for accounts and audit as follows:

(1) The Commission—

(a) shall cause proper accounts and other records in relation thereto to be kept; and

(b) shall prepare an annual statement of accounts in such form and containing such particulars, compiled in such manner, as the Minister may from time to time direct with the approval of the Treasury.

(2) The said annual statement shall be so framed as to provide, as far as may be, separate information as respects the principal activities of the Commission, and, in combination with the periodical statistics and returns rendered by the Commission, to show, as far as may be, the financial and operating results of each such activity, and the Minister and the Treasury shall exercise their powers under this section accordingly.

(3) The accounts of the Commission shall be audited by an auditor or auditors to be appointed annually by the Minister and in accordance with a scheme of audit approved by him and, if the Minister so directs, the accounts of the Commission as respects any part of their undertaking specified in the direction shall be separately audited by an auditor or auditors so appointed as aforesaid.

(4) So soon as the accounts of the Commission have been audited as aforesaid, they shall send a copy of the statement of accounts referred to in paragraph (b) of subsection (1) of this section to the Minister, together with a copy of the report

made by the auditor or auditors on that statement, and a copy of that statement and of any such report shall be included in the report which is under Part I of this Act to be laid by the Minister annually before each House of Parliament.

(5) The Commission shall compile and render to the Minister such periodical statistics and returns relating to each of their principal activities in such form and at such times as the Minister may direct, and the Minister shall lay a copy of any such statistics and returns before each House of Parliament:

Provided that, in giving any directions under this subsection, the Minister shall have regard to the desirability of requiring the Commission to compile and render statistics and returns on a basis which, in his opinion, is reasonably comparable with that of the statistics and returns required at the date of the passing of this Act to be rendered by railway and canal companies by or under the enactments mentioned in the next succeeding subsection.

Directions as to the form and content of the accounts of the Commission were issued by the Minister of Transport in July, 1949. These directions are reproduced in Appendix A. The accounts are to consist of a consolidated revenue account and a consolidated balance sheet, with a considerable volume of supporting detail.

It is of particular interest to note that the consolidated balance sheet of the Commission at 31st December, 1948, corresponds in form and manner of presentation with current commercial accounting practice. The double account system has been abandoned. The general principle adopted in regard to such assets of the former railway companies as require replacement (i.e. rolling stock, ships, plant, &c.) has been to introduce them into the accounts at their cost, depreciation being shown as a deduction. The first annual report of the Commission rejects the main principle of the double account system in the following words:

'It is desirable (1) that the book records of assets in existence at any time should, as a general rule, be related to their actual cost rather than to the cost of the original assets which they replace, and (2) that depreciation provided on such assets should also be related to the firm fact of their actual cost rather than to estimates of current costs of replacement, which may vary greatly from year to year.'

Current replacement costs are, in general, substantially higher than the cost of existing assets which were for the most part, acquired before 1939. The practice of the railway companies was to charge revenue account with an annual sum related to current replacement costs rather than to the actual cost of existing assets. The Transport Commission has preferred to base the depreciation charge on the actual cost of existing assets. In reply to criticism of this policy, the chief public relations and publicity officer of the Commission has pointed out, *inter alia*,

- '(a) that the Commission, unlike the railway companies, is under the obligation to redeem its capital by charge to revenue;
- (b) that, unlike the railway companies, the Commission is financed entirely by loan capital, with the result that so long as it depreciates in full the assets bought with borrowed money it will always be in a position to repay its debts; there is no question of building up an equity capital to keep pace with monetary depreciation.*

A scheme of audit has been approved by the Minister of Transport, and is here reproduced:

* *The Accountant*, 8th October, 1949.

**SCHEME OF AUDIT OF THE ACCOUNTS OF THE BRITISH TRANSPORT
COMMISSION APPROVED BY THE MINISTER OF TRANSPORT, DATED**

1st JULY, 1948

(2) The auditors shall examine the books, accounts and records of the Commission and shall report:

- (a) whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit.
 - (b) Whether in their opinion proper books of account and other records in relation thereto have been kept by the Commission so far as appears from their examination of those books and records, and whether proper returns adequate for the purposes of their audit have been received from every executive and department of the Commission, whose accounts have been examined and reported upon by such auditors or firms of auditors appointed by the Commission as are referred to in paragraph 3 of this scheme; and
 - (c) (i) whether the balance sheet and revenue account for the financial year, and any other account required to be included in the Commission's annual statement of accounts for that year are in agreement with the said books of account and records and with the returns examined and reported upon as aforesaid; and
(ii) whether in their opinion and to the best of their information and according to the explanations given to them the said balance sheet gives a true and fair view of the state of the Commission's affairs at the end of the financial year and the said revenue account gives a true and fair view of the operating results and the profit or loss for the said year, and any other such account gives a true and fair view of the matters to which it relates.
- (3) The Commission having expressed their intention of appointing, so far as is practicable, professional auditors or firms of auditors to audit on their behalf the books and records of the executives and departments of the Commission, the auditors are authorised, to the extent which is in their judgment reasonable, to rely for the purposes of their audit upon the audits carried out by any auditors or firms of auditors appointed by the Commission to carry out such audits, provided that:
- (a) the auditors approve the general lines of the work carried out by any such auditor or firm of auditors;
 - (b) the auditors are furnished by any such auditor or firm of auditors with answers to such inquiries and with such further information and explanations as they may require; and
 - (c) the Commission comply with the provisions of paragraph 4 of this scheme.
- (4) The Commission shall maintain proper systems of internal check and after consultation with the auditors shall take steps to ensure the integration of the programmes of professional audit and the provision of such liaison as may be necessary between the auditors and such other auditors or firms of auditors appointed by the Commission as are referred to in paragraph 3 of this scheme.

The auditors appointed under Section 94 of the Transport Act have become known as the main auditors, to distinguish them from the professional auditors who act on behalf of the Commission. The first annual report of the Commission records that the latter number some 130 firms. The division of function between the main auditors and the auditors appointed by the Commission is described in the first annual report in the following terms:

'The result of these arrangements is that provided the main auditors are reasonably satisfied with the machinery of internal check, including the appointments and the co-ordination of the programmes of the professional auditors appointed by the Commission, the most important aspect of the work of the main auditors is to be found in the examination of major matters of accounting policy, in the check of the final processes of constructing the consolidated position, and in the watch over the presentation of results.'

Section 3 (4) of the Transport Act, 1947, imposes upon the Commission the duty of securing that its revenue is not less than sufficient for making provision for the meeting of charges properly chargeable to revenue, taking one year with another.

Section 93 of the Act provides that the charges which are proper to be made to revenue are to include 'proper allocations to general reserve, proper provision for depreciation or renewal of assets and proper provision for redemption of capital'. By regulations made in 1947, in the case of stock issued as compensation under the Transport Act, the period over which provision must be made for redemption is ninety years.

VI. WATER COMPANIES. There is no general statutory form of accounts for water companies. The water supply of London is under the control of the Metropolitan Water Board. It is a very general practice to assimilate the accounts of water companies (as near as may be) to the form laid down for gas companies in Schedule B of the Gas Works Clauses Act, 1871—indeed, it is difficult to conceive a form better adapted for this purpose.

The audit of water companies is simplified by reason of the fact that the rates charged are, for the most part, fixed, instead of fluctuating with the quantity used. With regard to rates based on a sliding scale (for which see the Special Act) upon the rateable value of the houses, it is not usual to check the calculations involved exhaustively, but they should be *tested* to such extent as may appear desirable. Vacancies may sometimes be vouched by a declaration of the owner that the property in question has been vacant for *the whole* of the quarter. Allowances (which should be very exceptional) must be properly explained, while arrears and bad debts must both receive careful attention.

Most companies are empowered to make their rates in advance, and consequently their books will, at the date of the accounts, include revenue that has not yet been earned: due allowance must, of course, be made for this in the general balance sheet.

VII. TRAFFIC ACCOUNTS. (a) TRAMWAYS AND OMNIBUS COMPANIES. With the exception of the few tramway undertakings that are governed by the legislation affecting railways, there is no prescribed form in which the accounts of tramways and omnibus companies are to be presented; considerable variations will therefore be found in the mode adopted by different companies.

The accounts are usually prepared upon the double account system—permanent-way, rolling-stock, engines and plant constituting the items of capital expenditure. The auditor must be careful to obtain the certificates of the competent officials in regard to the maintenance of the capital assets.

It is considered, however, that the single account system should be employed to record the transactions of omnibus companies. Even in the case of tramways, the mere repair and renewal of fixed assets as they wear out will not, even approximately, charge a sufficient sum

against revenue to enable the true profit to be determined. The difference between the deterioration in intrinsic value and the amount that can usefully be spent from year to year in repairs and renewals is very marked indeed; while the very short mileage of even the largest tramways, as contrasted with a railway, further aggravates the deficiencies of the double account system when applied to tramways.

The traffic receipts must be carefully tested, commencing with the tickets, guards' books, or waybills (as the case may be), and tracing the receipts on to the traffic sheets and daily and monthly traffic books, and seeing that the whole amount received has been duly banked. Where the system employed does not provide a perfect internal check the auditor should certainly make suggestions for amendment, meanwhile redoubling his vigilance at the faulty point. It may, perhaps, seem superfluous to suggest the propriety of seeing that receipts are accounted for upon every day of the year. The only other source of revenue of any importance will be advertising; but, as this is almost invariably sub-let to a contractor, it needs no comment.

The expenditure—which should always be made by cheque, no payment out of traffic receipts being on any account permitted—must be carefully vouched; while the analysis thereof must, as far as possible, be verified. In particular, the apportionment between capital and revenue must be thoroughly scrutinised.

(b) **MOTOR CAB COMPANIES.** Here, again, the chief interest centres round the question of depreciation. One of the early companies, after announcing that, in addition to providing for upkeep, as far as possible out of revenue, one-sixth of the cost of each cab was being written off annually by way of depreciation, has passed out of existence.

In other respects there is little in connection with the audit of motor cab companies that calls for comment. The taxi-meters represent, for what they are worth, the only practicable check upon the takings of the drivers, and as such must be accepted; but the readings should, of course, be entered up by someone other than the cashier, if the record is to provide any check upon that official.

(c) **SHIPPING COMPANIES.** The accounts connected with marine traffic are subject to no special statutory provisions with regard to form. An explanation of this is probably to be found in the fact that no compulsory powers by way of the acquisition of land are necessary in the case of ships.

There is no essential difficulty in connection with shipping accounts, but the fact that it is both desirable and customary to show the net result of every voyage of every ship necessitates some very nice apportionment of the items constituting shore expenses and insurance.

The extent of an auditor's investigations will vary greatly in different cases: in the case of a single ship it is desirable that the audit be as exhaustive as possible; but in the case of one of the larger companies such a course would be quite as impracticable as in the case of a rail-

way. The actual extent in any particular case will thus be very largely a matter of arrangement and of expediency.

The following considerations may, however, safely be submitted, as they will in every case require to be dealt with in more or less detail.

Ascertain that freights and passage money are duly accounted for; that the apportionment of shore expenses is equitable; that the cost accounts (of capital expenditure) are not improperly manipulated (especial care being required where one cost account is kept for a whole fleet); that only structural improvements are debited to cost accounts; that proper depreciation is allowed—especially in regard to boilers; that outstanding freights and agents' balances are provided for in accordance with the documentary evidence; that unclaimed return passages are in order; that proper return of insurance premiums has been obtained for the time during which any vessel has been 'laid up', and, generally that insurance matters are in order; that the question of foreign exchanges has been dealt with upon a proper basis; and that no profits are taken credit for on account of uncompleted voyages.

Some shipowners, instead of insuring with underwriters against risk of total loss or damage to their vessels, raise an insurance fund wherewith to meet such losses by periodical charges against revenue. The effect, of course, is that, instead of profit and loss being debited with insurance premiums, it is debited with an instalment (probably somewhat in excess of that which would otherwise have been paid) which is credited to the insurance fund. At the same time, to make the insurance fund really effective when required, it is necessary that a corresponding amount of cash should be invested in readily realisable securities, the insurance fund thus becoming for all practical purposes a sinking fund. When any loss is incurred, the cost of replacing it is debited to the insurance fund account, a corresponding amount of investments being realised to provide the necessary cash. It need hardly be pointed out that an insurance fund can only become an effective provision against loss in the case of companies owning a large fleet of vessels, so that within their own experience they get a reasonable average of risk. Even here, however, it will sometimes happen that a loss occurs which will more than swallow up the whole of the accumulated fund, and the question then arises whether it is reasonable to bring forward the *debit* balance of the insurance fund account as an asset upon the balance sheet. If there is a reasonable probability that this debit balance can be extinguished out of future instalments within a short time, there is probably no objection to this course; but, in any event, it seems necessary that the balance should appear as a special item in the balance sheet, so that no shareholder may be deceived as to the actual position of affairs; and, in addition, the auditor would do no harm by drawing attention to the facts in his report.

OWNERS OF SINGLE SHIPS and SINGLE-SHIP COMPANIES almost invariably make no provision for depreciation; the auditor should not forget to append the necessary qualification to his report.

The auditor of single-ship companies must bear in mind that very often the accounts are all in one persons' hands—let him, therefore,

not omit to examine the voyage account book in detail. It is to be remembered, also, that the same manager often has control of the funds of several single-ship companies; the auditor, in consequence, should be on his guard against 'ringing the changes', with cash balances.

It is a good plan always to ascertain that no mortgage has been registered against the ship which is not recorded in the books. The title to ships, and mortgages thereon, depend on entries in the register kept at the port of registry. Inspection of the register, or of a certified copy thereof, is, therefore, to be undertaken as part of each audit.

VIII. ACCOUNTS OF LOCAL AUTHORITIES. The statutes relating to local government, which had become very confused, have now, to a large extent, been happily consolidated in the Local Government Act, 1933 (reproduced in Appendix A).

A study of Part X of the Act, commencing at Section 219, will show that there are three distinct kinds of audit, viz.:

- (a) By district auditor, who in any case must examine the accounts specified in Section 219. He will audit accounts made up annually to 31st March (Section 223) and has a power of disallowance and surcharge on 'every item of account which is contrary to law' (Section 228). Under Section 236 there is power for the Minister of Health to order the holding of an extraordinary audit at any time.
- (b) In boroughs, subject to the alternative below, there must be three 'borough auditors', two elected by the local electorate, called 'elective auditors', and one appointed by the Mayor, called 'Mayor's auditor'. No qualification is demanded of these borough auditors and it is difficult, in a serious work of this character, to use restrained language in condemnation of so anachronistic a system. Metropolitan boroughs are, however, subject to district audit.
- (c) It is now open to borough councils to elect, by passing a resolution, demanding a two-thirds majority, to adopt either the system of district audit referred to above, or a system of professional audit. If the first of these options is decided upon, then the system of audits by the borough auditors, mentioned under (b) above will cease to be in force, but if, on the other hand, the borough council should decide for professional audit, they may appoint professional persons under the seal of the corporation for such periods and on such terms as the council may think fit. The persons so appointed must possess one of the qualifications mentioned in the first chapter of this work. An auditor so appointed should 'include in or annex to any certificate given by him with respect to the accounts audited by him such observations and recommendations (if any) as he thinks necessary or expedient to make with respect to the accounts or any matter arising thereout or in connection therewith', but as will be observed, there is no power of surcharge such as is possessed by a district auditor.

Many boroughs already possess powers under special Acts to appoint professional auditors, quite apart from the general powers conferred by the 1933 Act.

The duties and responsibilities of a professional auditor would be determined by the terms of his appointment. His clients are the council, and he cannot exceed their instructions. It is advantageous, and usual, for the professional audit to be continuous.

The accounts of county borough councils in respect of health and education and certain other matters are, however, subject to audit by a district auditor.

Under the Education Act, 1944, the county councils and county borough councils are the local education authorities, and, under the National Health Service Act, 1946, they are the local health authorities. Both as regards education and health, the areas of two or more local authorities may be combined to form a joint board. The local health and education authorities are required to keep separate accounts in respect of health and education respectively. The accounts of county councils are, in any event, subject to the system of district audit, and uniformity is secured by making the health and education accounts of county borough councils subject to district audit.

The Audit Regulations, 1934, provide that, in the case of all local authorities subject to district audit, a financial statement must be certified by the district auditor. The form of this financial statement is set out in the Financial Statements (District Audit) Regulations, 1938. As the main purpose of the Financial Statement is to show the total sum upon which stamp duty is assessed, it is, for other purposes, of very limited value.

There is no statutory form of revenue account and balance sheet for local authorities in general, but the Accounts (Boroughs and Metropolitan Boroughs) Regulations, 1930, apply to the accounts of metropolitan boroughs and such of the accounts of municipal boroughs as are subject to district audit. These regulations prescribe a double entry system of book-keeping and provide for a revenue account on an income and expenditure (as distinct from a receipts and payments) basis, and, if more than one balance sheet is prepared, an aggregate balance sheet.

Apart from the boroughs to which the Accounts Regulations of 1930 apply, most of the larger authorities prepare accounts on an income and expenditure basis.

The accounts of local authorities are usually kept on the double account system, and separate accounts are kept for each fund of the authority, e.g. for general rates, housing, transport, education, &c. The annual abstract of accounts usually includes, *inter alia*, a separate revenue account, capital account, and balance sheet for each fund, and an aggregate or consolidated balance sheet in which the balances appearing on the separate balance sheets are summarised. Capital expenditure is shown in the capital account of the appropriate fund and the total appears in the balance sheet of the fund.

The sinking fund instalments must in all cases receive the auditor's close attention: he must satisfy himself as to their sufficiency for the

redemption of the loans within the periods prescribed; and verify the investments of the fund, both as to principal and interest. In practice it is not usual to keep a separate sinking fund account in respect of each loan, but it is important to ascertain that the instalments set aside will duly accumulate to the required amount; and, as the rate of interest obtainable on the investment of trustee securities is continually fluctuating, the calculations should be verified at every audit. Subject to certain restrictions, a corporation is entitled to invest its sinking fund instalments in its own stock.

The actual significance of a sinking fund and the method of dealing with it in the books of a corporation are not always so well understood as might reasonably have been expected. A sinking fund is created by periodically debiting instalments against revenue, and crediting the amount of such instalments to sinking fund account. A corresponding amount of cash is simultaneously set aside and invested, the interest as received being credited to a sinking fund account and reinvested. The instalments chargeable against revenue are so based that, by the time the loan in respect of which the fund has been created is redeemable, a corresponding amount of investments is available for its repayment. Upon the loan being repaid the sinking fund ceases to be a sinking fund proper, and becomes a reserve fund or an accumulated surplus.

The accounts of local authorities should be framed so as to meet the following requirements:

- (1) To supply such information as may be necessary to enable the officials to see that all moneys receivable are duly received, and that no accounts are inadvertently paid twice over.
- (2) To enable a proper system of supervision to be exercised over those charged with the handling of money or stores.
- (3) To enable the members of the council to exercise due supervision over the employees.
- (4) To enable the Ministry of Health to exercise due supervision over the local authority.
- (5) To enable ratepayers to judge as to the efficiency and economy with which the local authority discharges its duties.
- (6) To enable investors who have lent money to local authorities, whether upon mortgage or stock, to judge as to the soundness of their investment.

From the point of view of both ratepayers and investors, one of the most important accounts would be one containing, in tabular form, the estimated expenditure under each heading, the estimated amount of spontaneous income available to meet such expenditure, and the balance proposed to be raised by rate. These figures should be contrasted with the amount of spontaneous income actually received, the amount of rate actually realised, and the amount of expenditure actually incurred; thus showing the amount of the discrepancy between the estimate and the result, distinguishing between the discrepancy due to alterations in expenditure and that due to differences between the estimated and the actual income.

Care should be taken to see that all balance sheets represent a complete statement of assets and liabilities at the date thereof, and in particular accruing assets and liabilities should be brought into account. In several cases balance sheets have been published mis-stating the position of affairs by omitting outstanding liabilities of considerable amount, and in other cases assets have been omitted.

The question of depreciation in connection with the assets of local authorities is one of paramount importance, and one which of late years has been productive of most of the hostile criticism concerning local authorities' accounts. If, when application is made for borrowing powers, a local authority were required to obtain a separate sanction in respect of each separate item of expenditure, and the loan period of each sanction were fixed according to the estimated life of the asset to be acquired, as nearly as this could be determined, then the statutory sinking fund instalments would correspond exactly with the proper depreciation charge; and then the revenue accounts of trading departments, if charged with such sinking fund instalments, would show the true profit on such trading. Owing, however, to the system of granting loans for an equated period, there is, in point of fact, no such correspondence between the loan period and the life of each separate asset, and in many cases it cannot even be said that the loan period represents the average life of the assets proposed to be acquired. Where the loan period is shorter than the life of the asset, the charging of sinking fund instalments against revenue has the effect of understating the true profits; where, on the other hand, the loan period is longer than the estimated life of the asset, the converse position obtains. It is impossible for anyone looking at the published accounts of a local authority to form any reliable idea of the true position of affairs, because the necessary information is not available. It is suggested, therefore, that a table should be appended to all such statements of account, showing (1) the estimated life of all the various assets acquired, under suitable headings; (2) the amount of the sinking fund necessary to provide for the writing off of such assets out of revenue during the estimated life; (3) the amount of the sinking fund required by statute to provide for the extinction of the loan by the date of its maturity; and (4) in separate columns, the excess (or deficiency) of the statutory sinking fund, as the case may be. In order to arrive at the true profits of the undertaking the difference between these two last columns only need be taken into account; but in order to provide effectively for the renewal of assets as they wear out, it is necessary that revenue should be charged, in addition to the statutory sinking fund, with the *gross* amount of the deficiency thereof in respect of assets whose estimated life is less than their respective loan periods, as otherwise there will be no funds available to provide for the renewal of these assets when required, pending the time when—the corresponding loan having been redeemed—it becomes again possible to borrow the expenditure incurred in such renewal.

In conclusion, it may be pointed out that no form of accounts, however admirably designed, can serve any useful purpose unless steps be

taken to enforce a strict responsibility for accuracy on the part of those responsible for their issue. There seems no reason why members of the finance committee of a local authority should not be held as strictly liable to account as directors of a joint-stock company, nor any reason why the officers of a local authority should not be held as responsible as the officers of such a company. So long as the present system of immunity exists it would seem waste of time to prescribe modifications in the existing form of accounts, for, after all, the question of form is of minor importance as compared with the substance.

MUNICIPAL TRADING DEPARTMENTS. The audit of municipal trading departments is a subject which has of late years attracted considerable public attention. That municipal enterprise should be viewed with suspicion—or even hostility—in many quarters is by no means surprising when it is borne in mind that these trading departments represent either (1) monopolies which might otherwise have been undertaken by private persons, presumably at a satisfactory profit; or else (2) an active competition with the ratepayers themselves, who are thus called upon in a measure to subsidise their rivals in trade. It is, however, only in so far as the audit of these accounts is concerned that it is necessary to consider the subject here.

From the point of view of the auditor, the chief thing that calls for consideration is that the published accounts purporting to show the results of the trading should be *true* accounts, actually showing those results, and not merely accounts which, while perhaps satisfying the limited requirements of the Ministry of Health, may be insufficient to enable the true position of affairs to be discovered—or may perhaps entirely misrepresent that position. Although the point is by no means universally conceded, it is thought that the *personnel* of the proprietorship can have no material bearing on the form that the accounts should take, and that therefore the ordinary principles of accounting should in all cases prevail. If this be admitted, the accounts of a municipally-owned waterworks, tramway, or any other public undertaking, should be framed as nearly as possible upon the lines on which it is usual to frame the accounts of similar concerns owned by proprietary companies. If the accounts are to serve a useful purpose, they should be framed so that it may be possible to compare them with the results achieved by proprietary undertakings carried on in a similar business; and this, of course, is only possible if the apportionment of expenditure as between capital and revenue be made upon the ordinarily accepted lines. At the present time, however, this is impossible, because in the accounts of local authorities the question as to what expenditure is capable of being recorded as capital expenditure has in practice to be determined, not by the facts of the case, but by the willingness (or disinclination) of the Ministry of Health to allow the expenditure to be defrayed by the issue of a loan; and the Ministry's rules do not appear to be based on any accepted principles of accountancy. Thus, one general rule is that no loans shall be sanctioned to cover the expenditure of wages paid to permanent employees, even although those employees may have been continuously engaged for weeks (or months) on end

on bona fide capital extension; while, on the other hand, the Ministry will occasionally sanction a loan for purely revenue purposes.

When the necessity arises for making some direct provision for depreciation a special difficulty arises in this direction. With regard to water-works, where the theoretical principles of the double account system prove sufficiently accurate for most practical purposes, there is no tendency towards any very marked difference of treatment, and municipalities are quite content to comply with their statutory requirements, and to provide by way of a sinking fund for the gradual redemption of loans out of revenue, while at the same time maintaining their capital expenditure intact (or approximately intact) by charging all repairs and renewals against profits. The result is that these undertakings, which were originally purchased by the local authorities with borrowed money, are being gradually paid for by the local authorities out of profits; and only the excess profits, after so providing for the gradual payment for the undertaking, are applied towards the relief of rates. Under reasonably competent management no difficulty whatever ought to be experienced in arriving at this result, and in applying annually a reasonable surplus of trading profits towards the relief of rates. In some cases, however, the management has been defective, and in other cases the success of the undertaking has been handicapped from the outset by an unduly inflated capital account, which—combined with the lack of competent technical advice, and a desire to prove by results that the original enterprise was really justified—have produced a singularly unfortunate position of affairs in connection with some of the more speculative enterprises. Here, as has been already stated, no true profit can be arrived at—at all events during the earlier years of an undertaking's existence—by the strict application of the double account system. In addition to charging actual outlay in respect of repairs and renewals against revenue, a provision—and a fairly substantial provision—for depreciation is essential if the true results are to be shown. These facts have been overlooked (it is thought, in the first place inadvertently); and—now that their oversight has been challenged—attempts have been made to justify it that are hardly likely to meet with the acceptance of those who are competent to express an opinion on the subject. It has been argued that, inasmuch as there is no statutory provision *requiring* local authorities to provide for depreciation, it is unnecessary for them to make any such provision; and it has further been argued that the provision of the statutory sinking fund takes the place of—and is in substitution for—depreciation.

With regard to the first point, it has been aptly pointed out that no statute is necessary to supplement the common law principle that accounts (of whatever kind) should be true accounts. If, therefore, provision for depreciation be necessary to enable the accounts to show the correct position of affairs, it becomes equally necessary from a legal point of view. It may, however, further be pointed out, in the first place, that the statute law *does* require the capital assets of these undertakings to be 'maintained' out of revenue, and, further, that no profits are legally available to be applied towards the relief of rates until after such maintenance *and* sinking fund have been provided for.

With regard to the second point, as to whether provision for depreciation and provision for sinking fund are interchangeable terms, it must, of course, be clear to those who duly appreciate the object of each that the two are by no means identical. It might, of course, be argued that, so long as the assets are really maintained intact out of revenue, there is no urgent need to provide for their eventual renewal. But the legislature (there can be little doubt) altogether overlooked the question of depreciation, as such, deeming the statutory requirement that the assets should be 'maintained' out of revenue sufficient; but, for all that, it required the loans to be redeemed eventually, and—perhaps appreciating that 'maintenance' (taking a narrow view of the term) would not involve any provision for obsolescence—it seems to have attempted, although quite roughly and often quite unsuccessfully, to limit the term of each loan approximately to the life of the assets about to be acquired.

The policy of the (old) Local Government Board—if, indeed, its somewhat conflicting regulations can be said to be governed by any policy whatsoever—would appear to have been limited to an attempt to prevent money being borrowed for renewal purposes until the repayment of the original loan has been provided for out of revenue. In practice, however, this system will be found to result in extremely unequal charges to revenue, unless some serious attempt be made to equalise those charges by means of a provision for renewals, or other form of depreciation fund. Theoretically, loans are sanctioned for a term corresponding to the average life of the assets to be acquired therewith. Apart from the fact that the average life cannot be computed in advance with more than approximate accuracy, it is clear that—being an average figure—it does not correspond with the life of each separate item, with the result that a considerable number of assets will call for renewal before the repayment of the original loan has been provided for by the statutory sinking fund instalments. Whatever deficiency there may be under this heading at the date of renewal must then be provided for out of current revenue, unless some provision has been made in advance against the revenue of previous years. Thus, in practice, in all cases substantial payments for renewal purposes will have to be charged against revenue; and, that being so, the charge ought in all fairness to be equalised as far as possible over a series of years. The Local Government Board in the latter years of its life appears to have appreciated the difficulties caused by sanctioning loans for equated periods, accordingly the difficulties now explained will (very) gradually disappear. The present policy is to discourage borrowing for short-lived assets altogether.

IX. EXECUTORS' AND TRUSTEES' ACCOUNTS. The accounts of trustees in bankruptcy (and, if required, under deeds of arrangement) are audited by the bankruptcy department of the Board of Trade. An audit of the accounts of any other kind of trustee by the Court may be secured in an action brought against the trustees for the production of an account. With the consent of the trustee, of course, any interested party may appoint his own auditor to audit the accounts

of a trust; but such audit would be purely informal, and would bind no one.

Since the passing of the Public Trustee Act, 1906, however, a very workable scheme of audit has been provided by Section 13 of that measure, which is quoted *in extenso* in Appendix A. The auditor appointed under this section must be either a solicitor or a public accountant. He is provided with all necessary powers to make his audit effective, and at the conclusion of the audit is required to forward to the person on whose application it was instituted, and to every trustee, a copy of the accounts, together with a report thereon and a certificate signed by himself to the effect that the accounts exhibit a true view of the state of the affairs of the trust, and that he has had the securities of the trust fund investments produced to and verified by him; or, as the case may be, that such accounts are deficient in such respects as may be specified in such certificate. The fact that the accounts have to be 'certified' as being true accounts appears to limit them to a bare account of receipts and payments, which alone is capable of absolute verification.

The auditor will require to have produced to him the instrument creating the trust (or a verified copy thereof); the books, accounts, and vouchers of the trustees; and all securities and documents of title held by them on account of the trust. He must satisfy himself that all property passing to the trustees has been brought into account, and that all payments charged against such account have not merely been made, but are also properly chargeable against the trust fund. Where there is more than one trust fund, it is important to see that each is kept separate, and that all should be verified simultaneously. In particular must he see that the distinction between capital and income has been duly observed, remembering that in this branch of accounting the terms often have a special connotation.

In the space here available it is impossible to deal fully with what is in fact a somewhat complicated subject, but the following very brief résumé of the principal points to be considered will, it is thought, be sufficient for all ordinary purposes.

Unless barred by the will, the Apportionment Act, 1870, applies at the commencement of the trust under a will (but not under an *inter vivos* settlement), and on the happening of any event that changes the personality of those entitled to benefit thereunder (e.g. on the death of a life-tenant or the forfeiture of his, or her, interest), but in England there is no apportionment on a mere change of investments effected under powers given to the trustees, unless the Court so orders. This last statement does not apply to Scotland. In calculating apportionments, the date of death (or forfeiture, as the case may be) is to be taken as being the last day of the first of the two periods. That is to say, a person is deemed to be alive during the whole of the day on which he died. The income, or expenditure, to be apportioned is that for the period between the dates in respect of which it is payable, the precise date of payment being immaterial, although payments in advance, made to a testator in his lifetime are not apportionable in favour of a tenant-for-life under his will. Thus an apportionment of

dividends will (usually) be the dividends for the year, interim dividends being treated merely as a payment on account; but if the apportioned part allocated to the first period be smaller than the amount actually received during that period as interim dividends, there can be no refund in favour of the second period. Apportionments in the case of bank dividends, parochial rates, ground rents, &c., payable half-yearly, will be in respect of the half-year current on the happening of the event necessitating apportionment, and similarly with all classes of items accruing over shorter periods—e.g. weekly rents.

Special rules as to statutory apportionment arise under the Settled Land Act, 1925, Sections 47 (mines) and 66 (timber), but these are exceptional cases.

Where there is a trust, in favour of a life-tenant of residuary personal estate with remainder to some other party, in the absence of evidence to the contrary the Court will enforce what is called 'equitable' apportionment and will assume that it was the intention of the testator that the trust fund should be of a permanent nature and it will accordingly direct its conversion into consols, or other trustee securities, and allow the life-tenant only to receive such income as would have been received had conversion taken place as from the commencement of the trust. Various methods of applying this rule can be deduced from the cases. Even where there is express power to retain existing investments, this inference will be drawn in the absence of express provision to the contrary (*Howe v. Earl of Dartmouth*); but where there is sufficient evidence to show that the testator did intend the life-tenant to have all income received from existing investments—whether wasting or otherwise—the whole of the income is payable to the life-tenant, subject, of course, to statutory apportionment. The Law of Property Act, 1925, has taken leaseholds held under a trust for sale outside the operation of the *Howe v. Dartmouth* rule (see *re Brooker*, 1926).

Whereas the *Howe v. Dartmouth* rule operates to protect the enjoyment of residuary personalty in favour of persons coming late in a series, a similar equitable rule (derived from the decision in *re the Earl of Chesterfield's Trusts*) protects those who come early. Thus if a right to a vested reversion forms part of the residue of an estate, the amount which ultimately falls in must be discounted back so that its present value at the date of death (reckoning compound interest at 4 per cent. less tax) is deemed to be capital, the balance being paid to the tenant-for-life as income.

When trustees, in the due exercise of their powers, retain an investment, all moneys received in respect of such investment by way of interest or dividend in respect of periods subsequent to the death are to be treated as income, and all distributions in the form of capital—e.g. fully paid-up shares or debentures, where there is no effective option to take cash are to be treated as capital. The Trustee Act, 1925, expressly declares a 'sale of rights' to be capital.

In cases where a testator dies, leaving considerable debts and legacies payable out of capital, it is evident that, if the payment of these claims be postponed, the income received in the meantime will

be considerably in excess of the income on the residue of the estate. In the absence of express provisions to the contrary, the rule in *Allhusen v. Whittell* applies, and the life-tenant is only entitled to income on the residue—that is to say, the moneys necessary to pay debts, legacies, &c., must be provided not solely out of capital, but out of capital *and* the income *received* on the investment of such capital as is so applied up to the date of actual payment. The practical application of this rule would often involve very intricate calculations. It is usual, therefore, for wills to be drawn so as to exclude its operation, and to give the life-tenant the benefit of the increased income during the first year.

When verifying investments the auditor will require to satisfy himself not merely that they are actually in existence at the date of the audit, but as far as possible that they have been in existence ever since the date of their alleged acquisition; that no loss has been sustained to the estate through the unreasonable changing of investments (the rule against apportionment on changes of investment may easily bring about such losses), and that the investments are of a kind authorised by the instrument creating the trust. In the absence of express authority, the only proper trustee investments are those coming within the terms of the Trustee Act, 1925, Section 1. Section 2 of that Act regulates the power to purchase at a premium, and Sections 5 to 11 contain important supplementary provisions relating to the enlargement of powers of investment and precautions to be taken by trustees when making loans on property.

It frequently happens that an estate is so bequeathed as to be divisible between persons of different ages, with the proviso that the share of each is to be held in trust for him until the happening of a certain event—such as his attaining his majority (or, in the case of a female, on her marriage)—the beneficiary in the meantime receiving only the income on his, or her, share. In such circumstances it follows that the beneficiaries do not become simultaneously entitled to their respective shares in the principal; but the moment anyone becomes entitled to a share in possession he becomes entitled actually to receive such share, and—save by consent—the division (or partition) of the estate cannot be postponed. If the estate consists of investments that are readily capable of division, the problem is, of course, a quite simple one, for the beneficiary entitled to the partition may then have transferred to him (or sold for his benefit) his due fraction of each of the numerous investments held by the trustees; but when the estate includes mortgages, lands, or other non-divisible assets, some arbitrary method of arriving at the beneficiary's share becomes essential. If all beneficiaries are of age, the share of each may be mutually agreed; but if any one of the beneficiaries be under age, there is no means of obtaining his (or her) consent. The only course is then to apply to the Court, on an originating summons, when the Court will direct a 'partition' of the estate, and the ascertainment of the share immediately payable to the beneficiary entitled to a possessory interest, and the order of the Court will be a protection to all parties concerned. Upon payment of the amount found to be due to the beneficiary, he ceases to have any interest in the trust estate, and the residue of the

estate is then held in trust for the remainder of the beneficiaries, who alone are concerned in any subsequent fluctuation in the value of the trust investments.

It is especially important to remember that beneficiaries, unless of full age, have no power to consent to any variation in the terms of the trust.

CHAPTER VI

SPECIAL CONSIDERATIONS IN DIFFERENT CLASSES OF AUDITS

(Continued)

✓ **ACCOUNTS OF INSTITUTIONS. (a) CHARITIES.** The Charitable Trusts Acts, 1853 to 1939, require that the trustees or administrators of every charity to which the Acts apply shall, in books to be kept by them for that purpose, regularly enter or cause to be entered full and true accounts of all moneys received and paid respectively on account of such charity, and also shall on or before the 25th March in every year, or such other day as may be fixed for that purpose, prepare and make out the following accounts in respect thereto:

- (1) An account of the gross income arising from the endowment, or which ought to have arisen therefrom during the year ending on 31st December then last, or on such other day as may have been appointed for this purpose;
- (2) An account of all balances in hand at the commencement of the year, and of all moneys received during the same year on account of the charity;
- (3) An account for the same period of all payments;
- (4) An account of all moneys owing to or from the charity, so far as conveniently may be.

The accounts must be certified by one or more of the trustees or administrators, and audited by the auditor of the charity, *if any*. It will be observed that audit is not compulsory. Section 63 of the Charitable Trusts Act, 1853, empowers the Charity Commissioners to make such orders as they think fit in relation to the delivery and transmission of the said account and the form thereof.

It will be seen that charities are under no obligation to present an income and expenditure account and balance sheet, and, in the case of charities which publish accounts and a balance sheet, there are no statutory requirements as to the degree of disclosure. The accounts of some charities give less information than could be desired and there seems no good reason why charities which invite the public to subscribe to their funds should not be required to publish accounts which conform to present-day standards of disclosure.

The distinguishing feature of most charities' accounts is the receipt of subscriptions and donations. These will, of course, require to be vouched in the usual way; but, perhaps, the most effective check consists in the publication of a list of subscribers and donors along with the accounts.

An important matter, from the auditor's point of view, is that charities are not liable for income-tax if their objects can be proved to be 'charitable purposes' within the legal meaning of that phrase.

The full definition of a 'charity' for this purpose is contained in the Mortmain and Charitable Uses Act, 1888, Section 13 (repeating a statute of Elizabeth), and, generally speaking, includes the relief of poverty, the advancement of education or religion and purposes beneficial to the community as a whole. There must be no *power* to apply income otherwise. It is therefore incumbent on the auditor to see that tax suffered by deduction from rents and dividends has been recovered. Sometimes, too, where subscribers covenant to make annual subscriptions for at least seven years, they deduct tax; this, also, is recoverable.

(H) HOSPITALS. By the National Health Service Act, 1946, the former voluntary and local authority hospitals were transferred to public ownership. Regional hospital boards have been set up to administer hospital and specialist services in their respective areas. Individual hospitals or groups of hospitals are managed by hospital management committees, the members of which are appointed by the regional hospital board. Teaching hospitals have been given a separate status and each is controlled by a board of governors appointed by the Minister of Health.

By Section 55 (2) of the Act, every regional hospital board, board of governors of a teaching hospital and hospital management committee is required to keep accounts in such form as the Minister may, with the approval of the Treasury, direct. Every board and committee is also required to submit annual accounts to the Minister. The Act provides that these accounts are to be audited by auditors appointed by the Minister. A new branch has been set up under the Ministry of Health for audit purposes, and the auditors are known as Ministry of Health auditors. It is understood that the procedure is similar to that of district audit. As the hospitals are financed out of public funds, regional hospital boards and boards of governors of teaching hospitals are also required to submit to the Minister annual estimates of their income and expenditure during the following financial year. Hospital management committees receive their funds from their respective regional hospital boards and each committee is therefore required to submit to the regional hospital board an annual estimate of income and expenditure for the following financial year. The estimate submitted to the Minister by each regional board includes the estimates of the management committees in its area.

The forms in which the annual estimates and annual accounts of boards and committees are to be submitted are set out in the National Health Service (Hospital Accounts and Financial Provisions) Regulations, 1948. These regulations also include directions relating to the system of book-keeping which must be adopted. It may be observed that a double entry system is prescribed.

The accounting systems of most hospitals are, in general, very inadequate as instruments of administration and control, and published accounts give less information than could be desired. Lack of uniformity, both in the circumstances of hospitals and in their systems of accounting, makes comparisons difficult and unsatisfactory. Many

hospitals publish accounts which follow the form prescribed in the revised uniform system of hospital accounts, adopted by King Edward's Hospital Fund for London, the Metropolitan Hospital Sunday Fund, and the Hospital Saturday Fund. Under this system, expenditure is classified according to the nature of the expense, e.g. provisions, surgery and dispensary, salaries and wages, &c., rather than under departmental and functional headings. The accounts are supported by statistical tables showing the average cost of each in-patient per week, i.e. cost per bed, and the cost per out-patient attendance. These two units of cost are not adequate in relation to the very wide range of hospital activities; there is no information as to the separate costs of wards, theatres, X-ray department, laboratory services and so on.

In July, 1946, a committee was set up to formulate proposals for a set of accounts that would be applicable to all classes of hospitals. The committee was composed of representatives of the Institute of Hospital Administrators, the Institute of Chartered Accountants and the Institute of Cost and Works Accountants. The report of this committee, published in 1948 by the Institute of Hospital Administrators, included pro-forma rulings for books and statistical records and also for annual accounts which are recommended for adoption by hospitals.

The system of accounting proposed by the joint committee includes an income and expenditure account in which expenses are classified in three main groups, direct or basic services, indirect services, and ancillary and auxiliary services. Under each main heading there are sub-headings on a departmental and functional basis. The direct services group includes, in the words of the report, departments that are in direct contact with patients and which at the same time are common to most hospitals, e.g. wards, out-patient and casualty departments, diagnostic X-rays, theatres, laboratory services. The indirect services include administrative office, matron's office, stores control, kitchen, dining-rooms, training schools and laundry. The ancillary and auxiliary services include special departments which are not found in all hospitals, such as district nursing, physiotherapy and occupational therapy. The costs of such departments as the bakery are not shown in the income and expenditure account, but are spread over other departments, according to the services rendered. Where the allocation would of necessity be arbitrary, as, for example, in the cases of lighting, heating, water and rates, the total of these expenses is treated in the income and expenditure account as a separate service, and included under indirect services.

There are separate income and expenditure accounts for revenue-producing departments, e.g. private patients, farm and garden, canteen, and the surplus on each of these accounts is transferred to the general income and expenditure account. There are also separate accounts for income and expenditure in connection with research and other special purposes, and for activities financed by endowments; in these cases the balances on the income and expenditure accounts are not transferred to the general income and expenditure account, but are carried forward and appear as separate items in the balance sheet.

The accounts are to be supported by statistical tables showing the total cost of each department, and the cost per unit for each department; the units are adapted to the nature of the service, e.g. for wards, cost per patient-day, for the out-patient department, per attendance, for theatres, per operation, for training schools, per student-week.

Some of the account forms in the report of the joint committee are, by permission of the Institute of Hospital Administrators, reproduced in Appendix A.

The form of accounts prescribed by the National Health Service (Hospital Accounts and Financial Provisions) Regulations, 1948, are, in comparison with the system recommended by the joint committee, disappointing. The report for 1948 of King Edward's Hospital Fund for London comments on the Regulations:

'So far, however, the Minister has not felt able to require hospitals generally to adopt anything more than the simplest of systems on the old lines, owing possibly to the lack of sufficient experienced accountancy staff in the hospitals.'

(c) CHURCHES. The Parochial Church Councils (Powers) Measure, 1921, provides that the Parochial Church Council in each parish shall be a body corporate, charged with the duty of keeping proper accounts made up to 31st December in each year, which, after being 'duly audited', are to be submitted to 'the annual church meeting'.

In many respects the audit of church accounts is a peculiarly thankless task. Apart from the fact that they are hardly ever submitted to the auditor in anything approaching proper form it is often the case that no effective internal supervision is exercised, and frequently large sums will pass through, say a vergers' hands, without any proper check being kept upon his dealings.

The auditor must check everything he can, and try to teach his clients the elements of commercial caution; but it is probable that he will never feel quite happy with a church audit. The writer well remembers upon one occasion, being refused permission to count a balance of over £100 (practically a running balance) that was in the hands of the vergers: not long afterwards—but, nevertheless, after repeated warnings—the suspicions of the vicar were at length aroused, and the vergers were instructed to pay his balance into the bank. It seems unnecessary to add that he was unable to do so.

(d) COLLEGES AND SCHOOLS. These accounts call for but little comment. The usual method of audit may be said to consist of a 'cross' between that employed in 'charities' and 'hotels' (q.v.), but it may be added that only a detailed audit is likely to be found entirely satisfactory.

Many UNIVERSITY COLLEGES are subject to the Statute made by the Commissioners appointed under the Universities Act, 1877, under which duly audited accounts have to be submitted to the university. In most cases a tax is payable upon the amount of income received.

ENDOWED SCHOOLS are nominally under the control of the Charity Commissioners, to whom copies of the annual accounts should be forwarded. The principal point to be remembered is that the governors

have no power to apply the *corpus* of the endowment to current purposes.

XI. BUILDING AND FRIENDLY SOCIETIES, &c. (a) BUILDING SOCIETIES. The Building Societies Act, 1874, left the appointment of auditors to be dealt with by each society in its rules, but it was generally considered that at least two auditors must be appointed, the usual custom being for the directors to appoint one auditor and the shareholders the other. In many cases, however, qualified professional accountants were not appointed, and it is probable that most of the disasters that occurred in the 'early 'nineties' were attributable to this circumstance. This condition of affairs was partially remedied by the Building Societies Act, 1894, which required that at least one of the auditors should publicly carry on business as an accountant. Unfortunately, however, this Act only applied to societies registered after 1856. In the majority of cases the auditors so appointed have been chartered or incorporated accountants, but it will be seen that this is not required by the statute. At the same time there can be little doubt that the Act of 1894, combined with increased vigilance by the Registrar in the supervision of the annual returns of building societies, has done much to weed out the small ill-managed concerns that were formerly so common. There are, however, still a fair number of small societies that present difficulties to the auditor by reason of the fact that they are too small for any really effective system of internal check to be practicable. On the other hand, the comparatively few large societies which now conduct practically the whole of the building society business of the country naturally present no such difficulties.

The author's experience of building society accounts—and these remarks apply equally to every class of accounts included under this heading—has convinced him of the extreme importance, at least in the case of the smaller societies, of checking every addition, posting and voucher; of carefully verifying every amount received in redemption of mortgages or paid out to investing shareholders; of comparing every pass book with the ledgers, and both with the lists of balances; and of testing at considerable length the calculation of interest. The income received from properties in hand must be verified in every possible way; and, where such income does not seem to be a fair return upon the book-value of the various properties, the latter should either be revised or supported by a surveyor's valuation.

The deeds relating to all mortgages, and the securities relating to whatever other investments there may be, must also be examined by the auditor. The precaution is sometimes taken of requiring the society's solicitor to certify that such deeds are all in order, but it is considered that there is no obligation to require this to be done in every case. Here, as elsewhere, an auditor is not an insurer and, if he takes reasonable care to ascertain that the deeds securing property to the society appear to be in order, he will be protected. Cases of uncertainty or suspicion, however, certainly merit deeper investigation and reference to legal experts.

In the case of a building society of any pretensions the number of

deeds that call for inspection will be very considerable, and accordingly a method of saving unnecessary labour will be found acceptable. In all well-managed concerns it will be found that the deeds relating to each mortgage are enclosed in a separate envelope, upon the outside of which is endorsed a résumé of its contents. If this endorsement has once been verified and the envelope has been sealed, the view has been advanced that under normal circumstances no similarly detailed verification of the contents is necessary at subsequent audits. At each subsequent audit all fresh sets of deeds must, of course, be verified in detail, as must also the contents of those envelopes which for one reason or another have been opened during the current period, and upon which therefore the auditor's seal is not intact; but it has been suggested that where the seal remains intact, and where a sufficiently distinctive seal has been employed, any further detailed investigation is unnecessary. It should be sufficient for practical purposes to verify the contents of a few envelopes, taken at random, and also, of course, the contents of all envelopes which in the opinion of the auditor may by any possibility have been tampered with. Although the above procedure has the advantage that the auditor avoids the labour of examining every set of deeds at every audit, it is difficult to reconcile with the form of the auditors' certificate under Section 2 of the Building Society Act, 1894, by which the auditor is required to certify that he has 'at this audit actually inspected the mortgage deeds and other securities belonging to the society'. It is clear that an auditor who adopts such a labour-saving method runs the risk that an impudent fraud may be practised on him—in which event his possible defence against a charge of negligence would certainly be distinctly weak. In the annual report of the Institute of Chartered Accountants for 1943 (paragraph 25), it is stated that inquiries have been made as to whether an auditor could delegate to an assistant the inspection of mortgage deeds, having regard to the statement required by Section 2 of the Act of 1894. It appears that, in the opinion of the Chief Registrar of Friendly Societies, an auditor is entitled to delegate such part of the work as may be reasonable, including the inspection of mortgage deeds, to a responsible member of his staff. It is, however, pointed out that any liability to the society arising out of any failure in duty on the part of the clerk would be that of the auditor.

It must also be remembered that there is a statutory limit to the borrowing powers of a society, which must not be exceeded; and that the balance sheet and accounts are required to be kept in such form as the Registrar of Friendly Societies may prescribe. The statutory requirements concerning, and the prescribed form for, the accounts for building societies will be found duly set forth in Appendix A.

(b) **FRIENDLY SOCIETIES.** The Friendly Societies Acts, 1896 to 1948, contain certain provisions (for which see Appendix A hereto) which will guide the auditor in his work. Beyond these statutory requirements the general considerations discussed under the head of building societies will apply equally to the accounts of friendly societies, except that the different nature of the business carried on

will somewhat alter the scheme of audit and assimilate it more closely to that followed in the case of insurance companies.

Except in the case of small societies with (a) less than 500 members, and (b) assets of less than £5,000, the auditor must be an approved auditor holding an appointment under the Treasury. In the case of small societies which comply with the conditions mentioned above, the auditors may be two or more persons appointed as the rules of the society or branch provide; two partners in the same firm will satisfy the requirements of the Act. It is, perhaps, worth while to remember that the actuary employed at the quinquennial valuation need not be a 'public' valuer.

Friendly societies are required to keep hung up in a conspicuous place a copy of their last balance sheet, and to present a copy of their accounts free of charge to any member who may demand it; while every member has a right to inspect the books of the society at all reasonable times.

Under Section 14 (3) of the Friendly Societies Act, 1896, an auditor who, after notice, fails to furnish a signed return of the audit conducted by him, may be proceeded against by the Chief (or any assistant) Registrar or by any person aggrieved, and is liable to a penalty of not less than £1, and not more than £5.

(c) TRUSTEE SAVINGS BANKS. In connection with the audit of these accounts the Savings Banks Acts, 1863, 1891 and 1893, will require to be studied and in Appendix A will be found such portions of these Acts as affect the auditor in the discharge of his duties. The 1863 Act prescribes the form in which the annual return is to be made.

The remarks in connection with the accounts of building societies will apply, so far as they are relevant, with equal force to the accounts of savings banks. Emphasis must be laid on the importance of internal check with regard to cash received. It is highly desirable that the posting of ledgers and the receipt of cash be not in the hands of any one member of the staff. The examination of all the pass books is a most important feature.

Under Section 1 (1) of the Savings Bank Act, 1920, limits formerly set to the amount of the deposit, or of Government stock, credited to any depositor have been removed.

It is most important, too, to remember that under Section 6 (7) of the 1863 Act a list of the deposit ledger balances, checked and certified by the auditor(s) must be open to the inspection of every depositor, as regards his own account. The theoretical value of this as a safeguard against fraud is very great, although it is to be regretted that there is nothing to call the special attention of depositors to the provision and to the manner in which their own interests are served thereby.

Interest in favour of depositors is computed half-yearly to 20th May and 20th November. The annual account to be filed with the Commissioners for the reduction of the National Debt is made up to 20th November so that no question of accrued interest arises therein.

A statutory body called the Inspection Committee of Trustee Savings Banks exercises a general control over the business of these

banks and (under the Savings Banks Act, 1891, Section 8), a copy of the annual account must be furnished to this committee as well as to the Commissioners for the reduction of the National Debt.

(✓) **CO-OPERATIVE SOCIETIES, &c.** The consideration of the audit of these accounts need not be entered into fully. Certain statutory provisions (which will be found in Appendix A) must be complied with; but, in other respects, the audit will follow much upon the same lines as that of ordinary trading concerns.

Like all classes of audit enumerated in this section, the audit of co-operative societies' accounts—to be effective—must be detailed and should be continuous. It may be added that—at all events, so far as the smaller societies are concerned—the small number of employees militates against an effective system of internal check, which, combined with the small salaries usually paid, makes it important to take every precaution against fraud.

Since 1913, the audit of these accounts has been by one or more of the approved auditors. It must be added that the Co-operative Wholesale Society maintains an audit department staffed by persons who are on the panel of public auditors and that the audit of most local societies is now arranged for by the department mentioned.

XII. PROFESSIONAL ACCOUNTS. (a) SOLICITORS. In the course of their professional work, solicitors are accustomed to receive and hold money on behalf of their clients. Cases have occurred from time to time in which clients have suffered loss through the carelessness, and, in a few instances, the dishonesty of their legal advisers. Under the provisions of the Solicitors Act, 1933, and the Solicitors Act, 1941, measures have been taken for the protection of clients. Under Section 2 of the Act of 1941, a compensation fund has been set up for the purpose of compensating clients who have suffered loss through the dishonesty of a solicitor or his clerk or servant. Practising solicitors are required to contribute annually to this fund. Under Section 1 of the Solicitors Act, 1933, the Council of the Law Society is required to make rules as to the opening and keeping by solicitors of accounts at banks for clients' moneys, and as to the keeping by solicitors of accounts containing particulars and information as to moneys received, held or paid by them for or on account of their clients. By Section 18 of the Act of 1941, the Council is required to make rules in regard to trust moneys. The rules at present in force are the Solicitors' Accounts Rules, 1945, and the Solicitors' Trust Accounts Rules, 1945. The Act of 1941 also provides for an annual declaration of compliance with the Solicitors' Accounts Rules. Subject to a few exceptions, every practising solicitor is also required to produce annually a certificate by a qualified accountant that he has complied with the Solicitors' Accounts Rules. Effect is given to this latter requirement by the Accountants' Certificate Rules, 1946.

The effect of the Solicitors' Accounts Rules is to enforce on solicitors the necessity of segregating all moneys which they hold on behalf of their clients in a special bank account to be called 'client account'.

A solicitor may, if he thinks fit, keep more than one such account. Under Section 8 (2) of the Act of 1933, banks are precluded from setting off any money deposited in these client accounts against any other liability of the solicitor to the bank, so that clients for whom the money is held may, if the rules are observed, be assured that no creditors can compete with them.

The main requirements of the Solicitors' Accounts Rules as to the receipt of money are contained in Rule 3, which requires clients' money to be paid into a client account, and Rule 6, which prohibits the payment into a client account of moneys other than clients' money or money which, in the special cases covered by Rules 4 and 5, a solicitor is permitted to pay into a client account. Rule 6 is complementary to Rule 3, and is equally necessary, since, if a solicitor were permitted freely to pay his own money into the client account, the main purpose of the rules, i.e. the segregation of clients' money, would be defeated.

Rule 4 permits, in certain cases, money other than clients' money to be paid into client account. Under this rule, trust money, i.e. money subject to a trust of which the solicitor is a trustee, may be so paid in. This treatment of trust money has been permitted, because it may sometimes be difficult for a solicitor who receives money in connection with a trust to determine immediately whether he receives the money in the capacity of a solicitor or in the capacity of a trustee.

Circumstances may arise in which it would be unreasonable to require a solicitor to pay client's money into client account. In certain cases, a solicitor is permitted, and in other cases obliged, by the provisions of Rule 9, to withhold clients' money from client account. Under Rule 9 (1), a solicitor is under no obligation to pay into client account clients' money which is without delay paid over or endorsed over to the client or a third party and which is not passed by the solicitor through a bank account. Under Rule 9 (2), a solicitor is forbidden to pay clients' money into client account, if the client for his own convenience requests the solicitor to withhold it. He is also forbidden to pay into client account money which he receives in payment of a debt due to him from the client or in respect of costs incurred or an agreed fee for business undertaken or to be undertaken. These and other exceptions under Rule 9 are designed to meet practical difficulties which would arise from an unqualified insistence that clients' money must invariably be paid into a client account, and in no way weaken the main principle.

No money may be withdrawn from a client account except as permitted by Rule 7, or by written authorisation of the Council of the Law Society. Rule 7, *inter alia*, permits a solicitor to withdraw from a client account money which is properly required for or towards a debt due to the solicitor from the client or which is properly required for or towards payment of the solicitor's costs, provided that a bill of costs or other written intimation of the amount of costs incurred has been delivered to the client, and the client has been notified that the money held for him will be so applied. A very important aspect of Rule 7 is that it expressly provides that the amount withdrawn

in respect of any particular client or trust shall not exceed the total of money held in the client account on account of such client or trust. This protects the client against the risk that his money might be used to finance other clients of the solicitor. Expressed in terms of double entry book-keeping, this means that the balance in the client account at the bank must at no time be less than the aggregate of the credit balances on the personal accounts of the clients in the solicitor's ledger, without any deduction or offset of any debit balances on the personal accounts of other clients.

Rule 10 deals with the books and accounts which the solicitor is required to keep. Rule 10 (1) provides that:

'Every solicitor shall at all times keep properly written up such books and accounts as may be necessary (a) to show all his dealings with (i) clients' money held or received or paid by him, and (ii) any other money dealt with by him through a client account; and (b) to distinguish such money held, received or paid by him on account of each separate client and to distinguish such money, from other money held, received or paid by him on any other account.'

In an explanatory memorandum on the rules, the Council of the Law Society recommends that a solicitor should keep, *inter alia*, a cash book ruled with two separate principal money columns on each side, one for transactions on client account, and one for transactions on office account, or, alternatively, two separate cash books. It is also recommended that a solicitor should keep a ledger or ledgers kept so as to distinguish between transactions on client account and transactions on office account.

Rule 11 provides for the inspection at the Council's discretion, of a solicitor's books of account, bank statements, vouchers and documents.

Section 18 of the Solicitors Act, 1941, requires the Council of the Law Society to make rules with regard to certain trust moneys. It is to be noted that the Solicitors' Trust Accounts Rules, 1945, made by the Council under the provisions of Section 18, apply only to a solicitor who is a sole trustee or who is a co-trustee only with a partner, clerk or servant of his or with more than one of such persons. Such a solicitor is described in the rules as a 'solicitor-trustee'. The rules do not apply in cases where a solicitor is a co-trustee with a person who is neither partner, clerk nor servant.

The rules require a solicitor to open a separate bank account for each trust of which he is a solicitor-trustee. It has been noted above that, under the Solicitors' Accounts Rules, a solicitor is permitted to pay trust money into a client account. Subject to this option, which is recognised in Rule 3 of the Solicitors' Trust Accounts Rules, every solicitor-trustee who holds or receives money subject to a trust of which he is a solicitor-trustee is required to pay such money into the bank account of the particular trust, unless it is without delay paid over or endorsed over to a third party in the execution of the trust without being passed by the solicitor through a bank account. Subject to certain necessary exceptions, no money other than money subject to the particular trust may be paid into the bank account of the trust. No money may be withdrawn from a trust bank account except as permitted by Rule 7 of the Trust Accounts Rules, or by written authorisation of the Council of the Law Society.

Rule 10 (1) provides that:

'Every solicitor-trustee shall at all times keep properly written up such books and accounts as may be necessary: (a) to show separately all his dealings with money held, received or paid by him on account of each trust of which he is a solicitor-trustee, and (b) to distinguish the same from money held, received or paid by him on any other account.'

Rule 11 contains provisions for inspection in terms similar to those of Rule 11 of the Solicitors' Accounts Rules.

By Section 1 of the Solicitors' Act, 1941, every solicitor who handles clients' money is required to deliver annually to the Registrar of Solicitors* a certificate by a qualified accountant, unless he satisfies the Council of the Law Society that the delivery of an accountant's certificate is unnecessary, or is a public officer who does not take out a practising certificate. The accountant's certificate must state:

- '(i) that in compliance with this section and the rules made thereunder the accountant has examined the books, accounts and documents of the solicitor or his firm for the accounting period specified in the certificate; and
- (ii) whether or not from his examination of the books and documents produced to him and from the information and explanations given to him the accountant is satisfied and, if he is not satisfied, the matters in respect of which he is not satisfied, that during the accounting period the solicitor or his firm has complied with the provisions of the Solicitors' Accounts Rules.'

The rules made under Section 1 of the Act of 1941 and at present in force are the Accountants' Certificate Rules, 1946.

Neither Section 1 of the Act nor the Accountants' Certificate Rules require a complete audit of a solicitor's accounts. The preparation of a profit and loss account and balance sheet is not required. This section and the corresponding rules are directed to one limited purpose only, i.e. to ensure compliance with the Solicitors' Accounts Rules. It is to be noted that the certificate does not extend to the Solicitors' Trust Accounts Rules.

Rule 3 provides that the accountant who gives the certificate must be a member of one of the following bodies:

- (i) The Institute of Chartered Accountants in England and Wales.
- (ii) The Society of Incorporated Accountants and Auditors.
- (iii) The Association of Certified and Corporate Accountants.
- (iv) The Society of Accountants in Edinburgh†.
- (v) The Institute of Accountants and Actuaries in Glasgow†.
- (vi) The Society of Accountants in Aberdeen†.

The accountant must not be a partner, clerk or servant of the solicitor, and must not have been disqualified by the Council.

The period covered by the accountants' certificate must begin at the expiry of the last preceding accounting period for which an accountants' certificate was delivered, must cover not less than twelve months, must terminate not more than twelve months before the delivery of the certificate and must, where possible, correspond to the period for which the accounts of the solicitor are normally made up.

* The functions of the Registrar of Solicitors are performed by the Council of the Law Society.

†Now amalgamated as the Institute of Chartered Accountants of Scotland.

Rule 4 limits the extent of the examination which the accountant is required to make, in the following terms:

'(1) With a view to the signing of an accountants' certificate an accountant shall not be required to do more than:

- (a) make a general test examination of the books of account of the solicitor;
- (b) ascertain whether a client account is kept;
- (c) make a general test examination of the bank pass books and statements kept in relation to the solicitors' practice;
- (d) make a comparison, as at not fewer than two dates selected by the accountant, between
 - (i) the liabilities of the solicitor to his clients and, if trust money has been paid into the client account under the Solicitors' Trust Accounts Rules, to the *cestuis que trustent*, as shown by his books of account; and
 - (ii) the balances standing to the credit of the client account; and
- (e) ask for such information and explanations as he may require arising out of (a) to (d) above.

(2) If after making the investigation prescribed by paragraph (1) of this Rule it appears to the accountant that there is evidence that the Solicitors' Accounts Rules have not been complied with, he shall make such further investigation as may be necessary to enable him to sign the accountants' certificate.'

The accountant's duties in a normal case thus fall into two parts. He must first make a general examination of the book-keeping system and bank pass books and statements, and he is then required to make a more detailed examination of the position as at two selected dates. A more searching investigation is required only in cases where there is evidence of non-compliance with the Solicitors' Accounts Rules.

In an explanatory note to this rule in the memorandum on solicitors' accounts prepared by the Council of the Law Society, it is suggested the accountant's examination in a normal case should be:

- '(a) To examine the general book-keeping system in the office with particular reference to the questions whether proper ledger accounts for clients have been kept, whether these accounts show separately from any other transactions on behalf of each client, clients' moneys received, held or paid on behalf of each client, and whether separate cash books or cash accounts have been kept in order to segregate clients' money from any other money received, held or paid by the solicitor; and to make test checks of castings and postings of these books, and to "test vouch" the cash book.
- (b) To ascertain whether a client account is kept at a bank.
- (c) To reconcile the balances on the client account (bank account) with the cash book in which the solicitor records transactions on client account at the dates selected in (d) *infra*, and to test the daily lodgments with, and payments from, the bank with those shown in the cash book.
- (d) To extract client ledger balances at selected dates and to agree these balances with cash held on client account.
- (e) To enquire into and test check the system of recording costs and making transfers from client account to office account.
- (f) To scrutinise the ledger accounts in order to ascertain that payments from client account have not been made on any individual account in excess of cash held on behalf of that client and to vouch a few accounts with that object.
- (g) To scrutinise the office cash accounts and pass book with a view to ascertaining that clients' money has not been paid in error into the wrong account.'

If the accountant, at the solicitor's request, undertakes a complete audit, he may give an accountants' certificate without making the

specific tests mentioned, since a complete audit will entail a more thorough examination than Rule 4 requires.

It is not easy to carry out a full audit of the accounts of solicitors effectively without devoting considerably more time to the task than clients would be willing to pay for, and nothing short of a continuous audit appears to meet the complete necessities of the case.

One obvious difficulty which can never be entirely eliminated is the risk that a dishonest solicitor may receive money from clients and exclude from his books all record thereof. Further, practical experience of auditing reminds us that, in the case of this particular class of accounts, a solicitor who is, let us say, instructed to buy an investment with money provided by a client, may duly expend the money, but there may be nothing whatever in the books to show whether or not the investment has actually been delivered to the client himself. In the light of this remark and of others which will occur to the reader, it is evident that the limits of the audit of a solicitor's accounts cannot be very narrowly drawn.

There is the additional practical difficulty that in the case of many trusts, the solicitor will, quite properly, keep separate and distinct sets of books, with special bank accounts, &c.

When the system employed is such as Kain's System of Book-keeping for Solicitors (under which all transactions, including cash, are journalised in a special columnar form of journal so arranged that the general ledger accounts may be posted from the column totals), it would appear to be of especial importance that the auditor should satisfy himself that every entry in the cash journal is duly recorded in the proper column, for its insertion in the wrong column may easily produce an entirely false result. For this reason it is thought that most auditors will deprecate the employment of the system where the cash journal is kept by the cashier. These comments are made not with the express purpose of drawing attention to the shortcomings of a system in very general use, but merely because the system is, on account of its convenience, so frequently employed that the present work would not be complete without this passing reference to the difficulty of auditing accounts so framed. In the author's opinion the system is unrivalled where the principal (or one of the partners) himself keeps the cash journal; but in the case of those medium-sized firms where the principals cannot give individual attention to the books, and where the connection is not sufficiently large to make it practicable for the account-keeping to be organised upon a regular system of internal check, there would appear to be grave difficulties of verification that outweigh any immediate convenience of record.

The particular facts which occasion difficulty are (a) the great variety of the circumstances which affect the position between the solicitor and his different clients; it is often very difficult, when examining accounts in the clients' ledger, to see 'at a glance' whether the accounts are correctly and completely written up; (b) the great number of payments made in the course of business, for which no vouchers exist; as for example, where property is purchased for a client the title deeds are passed at once to the client.

Difficulty (a) can be surmounted only by the exercise of continuous vigilance, aided by experience. Generally speaking and in the absence of explanation, no account should run on for a prolonged period without a settlement being reached, and it should always be possible for the book-keeper to carry down balances so itemised as to explain their constitution. Further, the auditor would be well advised to go through the list of balances with a principal, referring to the actual ledger account in all cases that are not reasonably clear.

With regard to difficulty (b) it must be frankly recognised that it is not possible to vouch every payment made. It will be realised, however, that ordinarily no property of any magnitude will be purchased unless, at the time, the client puts the solicitor in funds; some assurance can consequently be gained from the intelligent scrutiny of personal ledger accounts above recommended. In this connection solicitors are peculiarly open to serious fraud on the part of trusted employees who have the opportunity to convey property to themselves at the expense of confiding clients. Here again the utmost degree of association of principals with all transactions is the first line of defence.

The auditor himself, however, can do much to surmount both the difficulties referred to by calling for the correspondence relating to given transactions and especially by comparing the copies of the statements of account rendered to clients with the relative ledger accounts.

The value of costs earned but not rendered is always an important item in a solicitor's practice, though some practitioners, for the sake of financial prudence, prefer to ignore it. Where it is to be included in the balance sheet the amount can be agreed approximately with the draft bills of costs after making allowance for those items actually rendered since the actual date of the balance sheet. It is important to remember that, where a charge is made to include out-of-pocket expenses, those expenses should not be brought in as an asset in addition to the accruing costs.

Careful inquiry should be made whether any fees are due to counsel. If so, these must be brought in as liabilities, a corresponding charge being made against the clients on whose behalf counsel was employed.

(b) STOCKBROKERS. A considerable amount of mystery appears to envelop Stock Exchange accounts, and the remark has frequently been made that the audit of brokers' and jobbers' accounts is altogether too technical a matter to be conducted safely by the general practitioner. The advantage of special practical knowledge on the part of the auditor has already been admitted, but it is contended that the desirable knowledge may readily be obtained, even by the general practitioner; and it is suggested that the necessity of 'specialism' has been greatly exaggerated.

If the audit of these accounts is to be of any value, however, it is necessary that it should be of the most detailed description: the danger of error or fraud—either of which might assume alarming proportions—is extremely great, and the utmost care and circumspection are, therefore, imperative. Particular attention should be directed to the name ledger, and continuations must also be carefully traced. The question

of 'splits' should also be kept in mind, as, although not usually a large item, it is a likely source of petty fraud. Numerous frauds have occurred through misappropriation by clerks of dividends belonging to clients but coming to the broker because the relative shares have been the subject of bargains transacted through him.

Perhaps the chief danger in this class of audits lies in the fact that in many offices there exists no regular system affording a reliable internal check, and no efficient supervision. To remedy this obvious weakness the visits of the auditor should be frequent, say, at least once during each account; indeed—although a periodical audit is doubtless useful, as affording a reliable periodical statement of accounts—the only really efficient audit of Stock Exchange accounts would appear to be one that is both detailed and continuous.

(c) ARCHITECTS. The accounts of architects are, perhaps, less frequently the subject of professional audit than either of the two classes of accounts just discussed, but this is a state of affairs which is always undesirable, and particularly so in cases where two or more architects are practising in partnership.

The accounts do not, as a rule, involve a particularly voluminous record and it is therefore desirable that in all cases the audit should be a detailed one. The fact that architects are frequently not business men makes it important that the auditor should take every precaution to guard his client from loss, both through actual fraud and bad book-keeping; it is therefore important for him to see that every item in the cash book is properly vouched, and, so far as possible, that all fees and commissions are duly accounted for. It may be mentioned here that the fees payable to an architect for supervising the erection of buildings are payable by way of a commission on the value of the work done, as certified by the architect for the purpose of assessing the payments to be made on account to the builder. There will always, at balancing time, be a considerable amount of accruing fees, which, although not actually due for payment at the time, constitutes an asset; a schedule of these items should be prepared and certified by the principals for inclusion in the accounts. Many practitioners, however, work their accounts exclusively upon a cash basis, and the plan always has much to recommend it when professions are concerned.

Another point that must not be lost sight of is that, in all important undertakings, a 'clerk of the works' is appointed to be on the spot, for the purpose of checking the material and workmanship employed by the builder. The clerk of the works is not infrequently appointed by the architect, but he is invariably paid by—and is the servant of—the architect's client; if, therefore, for reasons of convenience, his salary has been paid by the architect, it is important to see that it is subsequently recovered by him.

(d) MEDICAL MEN. Since the inauguration of the National Health Service, the private practice carried on by most medical men represents a very small proportion of their earnings. There are, however, a small number of medical men who accept only private paying patients. There

are so many different systems of book-keeping employed by medical men that it is difficult to afford any useful hints as to the method of audit in the space here available. It may be pointed out, however, that it is not, as a rule, either necessary or expedient for the auditor to go behind the debits in the patients' ledger, which, as often as not, are fixed at round sums by the practitioner without any strict reference to the number of visits. It is desirable, however, that the auditor should see that some efficient system of recording visits is in force, so that his client has all the facts before him when assessing the amount of his charges. The auditor should carefully check the credit side of the patients' ledger, noting in particular any allowances that have been made, and he should see that all cash credited to patients has been properly accounted for.

Where payments have been made on account of patients, whether for medicines, or for consultation fees, &c., it is very important that the auditor should see that they are properly charged up and collected in due course. Many practitioners employ one or more assistants, or dispensers, who are authorised to receive money, and where this is the case it is especially important that the system in use should, as far as possible, follow the ordinary business precautions against fraud. Where practitioners supply their patients with medicines it is also necessary that the accounts of druggists, &c., should be carefully checked, and an allowance will have to be made at balancing time for the value of drugs in stock. The fees receivable under the National Health Service are calculated on a capitation or 'unit' basis, and are received from the local executive council of the National Health Service.

It need hardly be added that where motors are the property of the practitioner, an adequate allowance must be made for depreciation, probably at the rate of 25 to 33½ per cent. per annum. Where, however, these are 'jobbed', it is equally important to see that the cost of hire to the date of balancing is included; or, if this has been paid in advance, that a proportionate part is held over as an asset.

The circumstances of medical practice are such that it is usually difficult to make a proper apportionment between professional and domestic expenditure in such matters as rent, rates, telephone, servants, wages, motor upkeep, &c. The best way out of this difficulty is to display the basis of apportionment on the face of the accounts; but, needless to say, the basis should be reasonable and, as far as possible, consistent from year to year.

CHAPTER VII

FROM TRIAL BALANCE TO BALANCE SHEET

THAT which forms the most important part of every audit—the questions of principle involved in the presentation of the balance sheet and revenue account—will now be considered. It is especially desirable that in every audit the principal should give these subjects his personal consideration, not merely because of their intrinsic importance, but also for reasons of policy that have already been dwelt upon.

Assets may be divided into two classes: (1) Those that represent expenditure on objects acquired with the purpose of being used for the purposes of the particular business in earning revenue; and (2) those that are either already cash or are acquired with a view to conversion into cash in the ordinary course of business; the former may be named **FIXED ASSETS**, the latter **CURRENT ASSETS**. A distinction is sometimes made between 'intangible' assets such as goodwill, trademarks, and copyrights; 'wasting' assets such as all those the substance of which is used up as part of the very operation of the business (e.g. mines or cemeteries); and 'fictitious' assets such as debit balances on revenue account or extraordinary expenditure carried forward. On these points it may be remarked, however, that for our present purpose intangible and wasting assets are really subdivisions of the general class 'fixed' assets, while fictitious assets (so called) need not be considered as assets at all. A debit balance on revenue account may be more suitably shown as a deduction from share capital. The importance of the primary division into 'fixed' and 'current' is further emphasised by the fact that the Companies Act, 1948, requires that the distinction be made in the balance sheet of every company.

✓ **VALUATION OF FIXED ASSETS. RISING PRICE LEVELS.** Fixed assets are those which are acquired for retention and use in the business. The period of usefulness is, in most cases, limited, and the original cost of such assets, less any sum realised on disposal at the end of the useful or working life, may be regarded as one of the expenses of carrying on the business. Viewed in this light, the most important difference between expenditure on a fixed asset and the current running expenses of a business is that, in the case of a fixed asset, the benefit from the expenditure is of relatively long duration while, in the case of other expenses, the benefit is of relatively short duration. The problem of valuing a fixed asset thus becomes the problem of allocating to the revenue account of each successive accounting period, during its useful or working life, a reasonable part of its net cost (i.e. original cost, less the sum realised on disposal). The fixed asset appears in the balance sheet at its original cost less the aggregate amount charged to revenue account by way of depreciation from the date of purchase up to the date of the balance sheet. The various methods of apportioning depreciation between successive accounting periods will be considered

below. Whichever method is adopted, an accurate assessment of depreciation is not, in most cases, possible, since neither the useful working life of the asset nor the sum that will be realised on its disposal can be known beforehand with precision; both must necessarily be estimates, and, as such, subject to a margin of error.

The amount at which a fixed asset appears in the balance sheet therefore does not represent, and is not intended to represent, the sum for which it could be realised at the date of the balance sheet. Neither is the amount appearing in the balance sheet in any way related to the sum for which the asset can, at that date, be replaced. The amount shown in the balance sheet represents an historical record of cost less the aggregate amounts written off or provided for depreciation.

The principle of valuing fixed assets at their original or historical cost less depreciation has been under heavy fire in recent years from many quarters. In a period of inflation or rise in the general level of prices, the cost of replacing industrial plant and equipment is substantially greater than the cost of the plant currently in use. The sums charged to revenue account by way of depreciation based on historical cost are insufficient to provide for the replacement of the plant at the end of its working life, and, if the profits of the undertaking are distributed 'up to the hilt', the deficiency can be made good only by the introduction of fresh capital. It is not therefore surprising that there are some who hold that the true profit of a business undertaking can be measured only by charging revenue account with an amount which is related to the cost of replacing a fixed asset rather than to the historical cost of the asset currently in use. It is argued that a profit ascertained after charging revenue with depreciation related to historical cost is a mere illusion, if the power to replace fixed assets is not fully maintained.

This attack on traditional methods of accounting is by no means confined to the question of the depreciation of fixed assets. No one contests the accepted principle that a profit is ascertained only after making provision for the maintenance of the capital of the undertaking. Those who are dissatisfied with normal accounting methods point out, however, that while the capital of a business, expressed in terms of money, may have been fully maintained or may even have increased, yet the real capital, in terms of goods and equipment and purchasing power, may have diminished. It cannot be denied that a growth in net assets, measured in terms of money, may conceal a decline in the volume of goods and equipment and the power to purchase goods and equipment which the money figures represent.

Of the cogency of these arguments there can be no doubt. On the other hand, to adapt and modify normal accounting procedures so that changes in the value of money may be reflected in accounts is quite another matter. It has been pointed out that charges to revenue which are related to the estimated replacement cost of fixed assets and any revaluation of the existing fixed assets by reference to replacement prices would be subject to continual revision in sympathy with variations in estimates of replacement costs, which may not remain stable for any length of time. This, it is suggested, would introduce

an element of instability into accounting statements and would vitiate comparisons.

With regard to current assets, it is urged that as yet no satisfactory accounting method of providing for the enhanced cost of replacing stocks or for the fall in the purchasing power of more liquid assets has yet been elaborated.

There is the further objection that radical changes in methods of measuring profit could not easily be reconciled with the existing framework of taxation and company law.

The problem has been examined in No. XII (dated 14th January, 1949) of the Recommendations on Accounting Principles issued by the Institute of Chartered Accountants. No fundamental changes in accounting methods are recommended. The earlier recommendations in regard to the valuation of stock-in-trade and fixed assets are re-asserted, i.e. that stock-in-trade should be valued at historical cost or lower market value and that the depreciation of fixed assets should be based on historical cost. The following recommendation is added:

'(1) Any amount set aside to finance replacements (whether of fixed or current assets) at enhanced costs should not be treated as a provision which must be made before profit for the year can be ascertained, but as a transfer to reserve. If such a transfer is shown in the profit and loss account as a deduction in arriving at the balance for the year, that balance should be described appropriately.

(2) In order to emphasise that as a matter of prudence the amount set aside is, for the time being, regarded by the directors as not available for distribution, it should normally be treated as a specific capital reserve for increased cost of replacement of assets.

(3) For balance sheet purposes fixed assets should not, in general, be written-up on the basis of estimated replacement costs, especially in the absence of a measure of stability in the price level.'

Such is the prevailing view.

It would be out of place, in the present volume, to indulge in speculations as to the course that developments in accounting technique may follow or ought to follow in the future. It may, nevertheless, be said with some degree of confidence that until accountants have devised methods, capable of general application, for providing for the maintenance of the real, as distinct from the money capital of business undertakings, it cannot be expected that the initiative will be taken in the field of taxation or company law.

METHODS OF DEPRECIATION. There are several methods by which the net cost of a fixed asset may be spread over its useful life. Whichever method is adopted, it is necessary to review the amount of the depreciation provision at frequent intervals. The amount written off in each accounting period is based upon an estimate of the working life of an asset. Such estimates cannot be entirely accurate, and, as they are revised, the provision for depreciation must be amended accordingly.

By the straight-line method, the net cost of the asset is spread by equal instalments over each successive accounting period throughout its useful life. This method is recommended by the Institute of Chartered Accountants as being the most suitable for general applica-

tion. By the reducing balance method, depreciation is calculated at a fixed percentage on the balance on the asset account as diminished by amounts previously written off or provided. This method is very widely used. If the straight-line method is employed, it is necessary to keep a separate record of each of the items which make up a single ledger account. Where the items are numerous, as they frequently are in the case of plant and machinery, such a record may take the form of a plant register, in which the original cost of each individual item, and the successive instalments of depreciation will be shown. If the reducing-balance method is employed, the importance of a plant register is perhaps not quite so apparent, since depreciation may be taken as a percentage of the balance on the ledger account. Unless a plant register is kept, however, it is not easy to discover how much is included in the ledger balance, at any given moment, in respect of any particular item of plant. When an item of plant is put out of use, correct accounting requires that adjustment should be made to eliminate from the ledger account the amount included therein in respect of the discarded item. Unless there is a record of the history of each item of plant, there is a serious risk that discarded assets may be carried forward as a constituent part of a composite ledger balance. A statistical record such as a plant register should therefore be kept, whichever method of depreciation is employed, if the items represented by a single ledger balance are sufficiently numerous to justify it.

The reducing-balance method requires the employment of a much higher percentage than is necessary under the straight-line method. The mathematical result of the reducing-balance method is that a relatively large proportion of the cost of the asset is charged to revenue account in the early years of its life, and a relatively small proportion is charged in the later years. If the life of the asset is short, the disparity is very pronounced. There seems to be no logical justification for a method which charges the revenue accounts of successive periods with unequal and diminishing sums. From the cost accounting point of view, the disadvantages are obvious, since an article made on 31st December ought not to appear to cost more than a similar article made on the following day. The arguments which have been advanced in support of the method cannot survive critical examination. It has been said that the cost of repairs and maintenance becomes greater as a machine becomes older, and that the increasing charge for repairs offsets the diminishing charge for depreciation. While it is certainly true that the cost of repairs must increase in the later years of the asset's life, there are no grounds for supposing that the decline in these expenses will be in exact correspondence with the progressive reduction in the charge for depreciation. Such an equality could never be anything but fortuitous, and is unlikely to occur in most cases. There is much to be said for equalising the annual charge for repairs by charging revenue account with a fixed annual sum, the credit being made to a repairs equalisation provision. If repairs are treated in this way and depreciation is calculated on the straight-line method, the successive annual revenue accounts bear an equal charge in respect of the original cost of the plant and the cost of its maintenance.

Under the sinking fund method of providing for depreciation, revenue account is debited with fixed annual instalments, and an equal amount of cash is used to purchase an investment. The instalment is calculated at such annual sum as, accumulated at compound interest, will produce an amount equal to the cost of the asset, less its value on disposal at the end of its working life. The question whether the use of an externally invested sinking fund is financially justified seems to depend on the use which might be made by the undertaking itself of the instalments to be set aside. If capital can be employed to return 10 per cent. it seems rather foolish voluntarily to restrict that rate to 3 per cent. On the other hand a sinking fund which is found to be unrealisable when its use is required is of course a mere delusion.

As regards plant and machinery, there may be a large number of individual items of varying ages. In such cases, the annual expenditure on replacements may not vary very greatly from one year to another, and hence there is no need to accumulate large liquid resources over a period of years. The sinking fund method is suitable in cases where heavy expenditure on replacement occurs at the end of a long period. Except in the case of public utility undertakings, this method is not very frequently used in practice.

Under the annuity method, a fixed annual instalment is credited to the asset account which is debited with an amount representing interest, calculated upon the diminishing balance of the asset account. The fixed instalment is debited to depreciation account, which is credited with the amount representing interest on the capital invested in the asset. The result is that the net amount charged to revenue account grows progressively greater each year. It is argued in favour of this method that as the asset is written down, the amount charged to revenue account is represented by an increase in the working capital at the disposal of the undertaking. The progressively increasing net charge for depreciation less interest is offset, the argument runs, by the increased profits derived from the increasing working capital. This argument assumes that the business is in a position to make profitable use of the annuity instalments which are left therein. On the other hand it may be suggested that, while it is essential, for certain purposes of comparison, to take into account interest on the capital employed in a business, the annuity method of depreciation has a distorting effect on the trend of profits. It is quite true that comparisons of the profits earned by a business in different periods, or of the profits earned by separate undertakings are misleading if they are made without reference to the capital employed in earning the profits. It is argued with some force that cost accounts do not provide reliable bases of comparison unless interest on capital employed is included as a part of cost. It is also true that a calculation of depreciation on the annuity method provides the readiest means of judging the comparative cheapness of different types of assets, and of deciding whether the short-lived and comparatively inexpensive asset is, or is not, in the long run more expensive than the more costly and more permanently built asset, assuming the working capacity of each to be equal. The annuity method of depreciation, however, is not designed

to correlate the profit of a business with the whole capital employed in earning that profit, and there seems to be no good reason for adopting a method which, by taking into account the capital employed in one individual asset, merely has the effect of spreading depreciation unevenly over successive accounting periods. The annuity method is, in practice, very seldom used. The recommendations of the Council of the Institute of Chartered Accountants in regard to depreciation are reproduced in Appendix A.

For taxation purposes, allowances are given in respect of the cost of certain fixed assets. These allowances are not evenly spread over the relevant years. The inequality is particularly marked in the case of plant and machinery; including the initial allowance of 40 per cent. of the cost, more than half the cost of plant and machinery may be allowed as a deduction from profits, for purposes of taxation, in a single year. In some cases, companies have adjusted their depreciation charges correspondingly, but this cannot be regarded as good accounting. The Council of the Institute of Chartered Accountants has recommended that, for accounting purposes, normal methods of depreciation should be maintained, thus avoiding any distortion of profits before taxation.

The special features in connection with the depreciation of various classes of assets must next be considered.

FREEHOLD LANDS may quickly be dismissed—they ordinarily suffer no depreciation. Fencing, and other similar works, would, of course, depreciate, but the item would not usually be of sufficient importance to require consideration. If, however, it became a large item, it should be treated separately as plant (q.v.). Liability to loss from earthquake, volcanic action, or coast erosion will, of course, have to be taken into account in all suitable cases; another exceptional case is the cultivation to exhaustion of virgin land.

FREEHOLD BUILDINGS depreciate to an extent varying greatly according to the quality of the workmanship and materials employed in their erection. The amount on the ledger account will frequently include freehold land, which, as we have seen, does not depreciate; the depreciation will therefore be confined to the building itself. If the instalment plan be adopted, from $1\frac{1}{4}$ to 3 (or even 5) per cent. of the original amount may be deducted annually; if the annuity method be used a fixed sum debited to revenue, which, after crediting interest, will write the asset down to zero in from, say, 50 to 150 years; or, if the sinking fund system be preferred, such a sum may be set aside as will accumulate to the cost of the building in that time. In each case all current repairs will have to be borne by revenue, in addition to the depreciation.

LEASEHOLD LAND AND PREMISES. The premium paid for leases may be regarded as the purchase-money paid for a terminable annuity of the difference between the annual value of the property and the annual charges. The most suitable method will be to charge a

proportionate part of the term against each year's revenue. Almost invariably the termination of a lease finds the late lessee liable to a heavy claim for dilapidations; this claim will frequently amount to one year's rent, or even more, and it is therefore a convenient and prudent course to deduct about one year from the unexpired term of the lease before making the depreciation calculations. All fixtures that are technically 'landlord's fixtures' must be lost to the lessee when the lease expires, and therefore must be depreciated accordingly. All repairs are, of course, chargeable to revenue; but they may be averaged by the temporary or permanent employment of a provision for repairs account through which revenue is charged with a fixed amount annually, the difference between the actual expenditure and the annual charge being brought forward as a liability, or (where it is certain that heavy repairs have relieved future years) as an asset.

Before leaving this point it is well to bear in mind that in the case of exceptionally long leases, or exceptionally badly built premises, it may be necessary to increase the annual charges for depreciation beyond the usual rate, so to provide for the rebuilding of the structure during the lease.

LICENSED HOUSES present some rather special features. The goodwill attaching to the licence gives the lease or freehold of licensed premises a market value greatly in excess of the real value of the buildings. A licence on freehold premises does not depreciate, but a licence on leasehold premises passes away with the premises, and must therefore be depreciated like a lease. A licence may at any time be withdrawn—either for misconduct or for no reason—but this is a contingency outside the scope of depreciation.

MINES undoubtedly depreciate in direct proportion to the amount of mineral extracted. Legally, however, and subject to articles, depreciation need not be provided for by a mining company before declaring a dividend. Where depreciation is provided the correct method appears to be to write off annually such proportion of the total cost (less residual value of plant) as the year's output bears to the estimated contents of the mine, or—in the case of a lease—such proportion of the total cost as the year's output bears to the estimated total output during the lease.

On the other hand, it must not be forgotten that there is so much uncertainty about mining ventures that it would be practically impossible, merely by the adoption of any system of accounts, to ensure that the whole of the capital of the undertaking was always maintained intact; while the persons who invest in this class of concern would doubtless object to large funds accumulating in the hands of directors, and earning a low rate of interest, that might legally be distributed as dividend, even though in point of fact they constitute a return of capital. In consequence, it may be the practice to make no provision for depreciation, but this should be disclosed so that the shareholders may be aware that their dividends include a partial return of their capital.

MACHINERY depreciates by wear and tear and by becoming obsolete. In addition to charging all repairs and (partial) renewals to revenue, such an amount as is calculated to reduce the assets to 'scrap' value at the end of their working life should be written off annually. The straight-line method is the most suitable for this asset. Loose tools are most conveniently dealt with by means of a revaluation. It is desirable that a sound practical opinion be obtained as to the precise rate to be adopted in any particular case, and a thorough revaluation from time to time is very helpful. A rise in current prices of new machinery, &c., is no reason for suspending the depreciation charge: on the contrary, it points to the probability of heavier outlays for upkeep.

Reference should here be made to the valuable assistance which may be obtained from a plant register such as was described at an earlier point of this chapter.

✓ **PATENTS** are virtually leases of a monopoly, and although it is possible that some value—in the nature of goodwill—may remain after a patent has run out, it seems desirable that the cost thereof should be written off within the period of its life; and the period may obviously be shorter where the article patented is not a commercial success. Renewal fees seem to correspond to ground rents. Where a patent has not been purchased, but remains the property of the original patentee, it is very undesirable that the item should be treated as an asset at all, except to the extent of its actual cost in fees, &c.

A similar mode of treatment will apply to **COPYRIGHTS**, except that their commercial value has usually expired long before the copyright has run out. (See further under 'Publishers' Accounts, page 91.)

SHIPS undeniably depreciate, although the rate at which they do so is so variable that no general rules can be given that would prove of any practical utility. The amount of depreciation is usually certified by a competent surveyor, and therefore—so long as his report looks plausible—the auditor is relieved from undue responsibility. As already stated, it is almost unknown for a single-ship company to provide for depreciation, it being inadvisable to allow a large depreciation fund to accumulate in the manager's hands. So long as the auditor's report makes it perfectly clear that no depreciation is being laid aside, and so long as the Courts see no illegality in such a course, there does not appear to be any valid objection, subject to articles, from an auditor's point of view, that is not outweighed by the resultant advantages. A single-ship company is obviously a 'non-permanent' undertaking.

✓ **REPAIRS** will, in all cases, require to be charged against profit and loss; but, with a view to equalising profits, it is sometimes advisable to charge a fixed sum to profit and loss, and to credit that sum to a 'provision for repairs account', against which account the cost of actual repairs will be debited. Except in very special cases, however, a debit balance on the provision account should not be

passed as an asset. If the amount expended upon repairs is below the average of previous years, it may be desirable to reconsider the value of the property itself.

✓GOODWILL in its relation to the balance sheet is a subject more difficult to discuss in theory than to deal with in practice. Obviously private individuals may do as they wish and partners may take any course which they mutually agree. In the case of a company, however, it may be taken as an invariable principle that goodwill does not appear in the books unless purchased; and, when purchased, it appears at cost. By most practical men this cost is understood to represent an expenditure which is sunk in acquiring business advantage and in their minds little question of 'value' arises. Persons who regard goodwill in this light are right in saying that goodwill does not depreciate, although its exchangeable value at successive points of time may fluctuate. Hence, anything which is written off the figure appearing in the books constitutes an 'inner reserve' because it represents something taken from the profits of the company which is not an expense necessarily to be borne before profits are arrived at. For this reason, sums so allocated to the writing down of goodwill are properly to be debited to appropriation account and not the profit and loss account. It must be plainly understood, however, that according to this view, there is no necessity for the amount of goodwill account to be written down. It is thought that the only counsel which ought to be given to the auditor in this matter is that if any sum is carried to the credit of goodwill account and if the taking thereof from profit is likely to prejudice the interest of any section of the members, then the transfer ought to be plainly indicated on the face of the accounts, and if the transfer is clearly *ultra vires*, the matter ought to be referred to in the auditor's report.

Remarks on this subject would not be complete unless reference were made to a theory of goodwill which puts the matter in an entirely different light. This is the 'super profit' theory which regards the purchase of goodwill as a discounted capital payment made in advance, in anticipation of the subsequent receipt of profits in excess of the remuneration of personal management plus a reward for the use of capital consonant with the risk of the particular case. Putting the matter another way, the purchase of goodwill is equivalent to the purchase of an annuity equal to the annual amount of the super profit. Economic forces tend to reduce the super profits to the level of commercial profits and consequently the annuity so described must be taken as a terminating annuity. It is mathematically true that the purchase price of such annuity can be calculated with accuracy and, inasmuch as the imaginary annuity terminates, it follows that a proportion of each instalment thereof which comes back to the business ought to be allocated to the amortisation of the original capital purchase.

It is not considered to be within the province of this work to pass any judgment upon the divergent points of view so described and the only comment which need be made is that it would probably be extremely difficult to find in practice an example of the scientific

allocation of profits to goodwill such as the annuity theory demands. Unless there is some direction in the regulations of the company the auditor may safely keep the purchase price of goodwill untouched.

✓ **INVESTMENTS** do not depreciate in the strict sense of the term, unless they are of a wasting nature such as shares in mines or plantation companies. All reference to that peculiar class of investments which is constituted by holdings in subsidiary companies (as defined by the Companies Act, 1948) must be ruled out for the moment, for the subject will be dealt with hereafter as its importance deserves. The balance sheet treatment of other investments turns on the question whether they are of a fixed or current nature. This question is often difficult to decide and the only thing which may usefully be said is that it depends on the intention with which the investments are held. The usual practice, where investments are clearly fixed assets, has always been to state the current market price as a note on the face of the balance sheet, and the Companies Act, 1948, now requires the disclosure of the aggregate market value of a company's quoted investments other than trade investments, if such value differs from the amount at which the investments appear in the balance sheet. Reference should be made to what has already been said on the subject of trust and investment companies.

In the case of investments of sinking fund instalments designed to provide a specified sum at a definite future date, fluctuation in market value is obviously of no importance; but the realisable value of the investments at the date when their realisation is contemplated is, equally clearly, a most important question. Any fall in values which can reasonably be foreseen should therefore be provided against and the sinking fund instalments should be modified accordingly; but casual fluctuation may well be disregarded and such shares may properly be stated in successive balance sheets at cost, subject to compliance with the above-mentioned requirements of the Companies Act, 1948.

On the other hand temporary investments, which may at any time require to be reconverted into cash, should in all cases be treated as current assets, and should be valued at their original cost or realisable market price, whichever for the time being may be lower, and any loss arising from such revaluation should be charged against current profits, or against any provision accumulated for the purpose. There is no real reason why subsequent recovery of the price should not be credited to profit, although the advisability of prudence in this connection is obvious.

✓ **VALUATION OF CURRENT ASSETS.** Current assets are cash and bank balances and assets which will, in the ordinary course of business, be converted into cash. The general rule in regard to valuation is that no current asset should be included in the balance sheet at a figure greater than either its cost or its current realisable value. In this way, while no potential profit is anticipated, losses are taken into account. The rule is, obviously, one of prudence. It is possible to hold,

as a matter of theory, that it is inconsistent to provide for expected losses while ignoring profits which have not been realised. The auditor, however, while he may recognise certain inconsistencies in accepted methods, is primarily concerned with the principles of valuation which are in fact generally accepted and applied.

STOCK-IN-TRADE. The accepted principle is that stock-in-trade should normally be valued at the lower of cost or market value. Market value has often been interpreted as the cost of replacing the stock at the date of the balance sheet. This interpretation cannot be justified on the principle that it is necessary to make provision for expected losses, since so long as it is expected that the goods will be sold for a price which, making allowances for expenses before sale, will be in excess of their cost, no loss is involved. This point is expressed in paragraph 121 of the Recommendations on Accounting Principles, issued by the Institute of Chartered Accountants, in the following words:

'The fact that at the time of valuation the goods could have been acquired at a sum less than their cost only indicates that the expected profit is less than it might have been had it been possible to acquire them at the accounting date—a possibility which often does not exist in view of the quantity held and of the fact that in many cases purchases have to be made for later delivery; the circumstance has not caused a trading loss but only indicates that the ultimate results under other conditions might have been better.'

The alternative interpretation of market value as representing net realisable value at the date of the balance sheet is adopted in paragraph 129 in the Recommendations, as follows:

'Market value should be calculated by reference to the price at which it is estimated that the stock-in-trade can be realised, either in its existing condition or as incorporated in the product normally sold, after allowing for expenditure to be incurred before disposal.'

The principle adopted in the Recommendations is therefore that, while provision must be made for a potential loss, stock-in-trade should not be valued below the amount required to achieve this result.

If, despite the fact that the net realisable value remains above the actual cost of the goods, the stock nevertheless is valued at a replacement price which is below actual cost, the consequence is that the profit of the period is unduly deflated. It follows that the profit of the subsequent accounting period will be inflated to a similar extent.

The effect of valuing stock at the lower of cost or net realisable value is that provision is made for expected losses, but no credit is taken for unrealised profits. Although this is the general rule, there are, in practice, certain exceptions, notably in the case of tea and rubber-producing companies and certain mining companies. The usual practice in undertakings of these types is to value the unsold produce at the price subsequently realised less selling expenses, with the object of including in the revenue account of each year the profit ultimately realised on the output of that year. In justification of this practice it is pointed out that by the time the accounts have been completed, the goods will usually have been sold. Despite this circum-

stance, the fact remains that, if this method is adopted, credit is taken for a profit not realised at the end of the accounting period.

The valuation of work in progress in connection with long-term contracts of an engineering or building character provides another important example of a departure from the general rule. Work in progress on uncompleted contracts of this kind is commonly valued so as to include a proportion of the expected profit. It is usual to make a very cautious and conservative estimate of the expected profit, making generous allowance for all possible contingencies which may conceivably lead to unforeseen expense in the future, and no profit is usually taken unless a reasonable proportion of the work has been completed. There is, nevertheless, a breach of the normal principle that profit should not be anticipated.

The reason for valuation above cost is that otherwise the profits shown by the accounts would fluctuate in a very marked fashion. It may happen, if contracts are in progress for a prolonged period, that, in one accounting period, a large number of contracts are completed, while, in the next accounting period, only a small number of contracts are completed. If work in progress were valued uniformly at cost, credit being taken for profit only as and when contracts are completed, a very large profit might be shown in the revenue account of the first period, while the accounts of the second period would show a much smaller profit or even a loss. It cannot be denied that, if work is proceeding at an even rate throughout both periods, and if all contracts yield a uniform rate of profit, such results would be in the highest degree misleading.

The general acceptance of the practice of valuing work on long-term contracts above cost involves a tacit admission of the proposition that profit is not necessarily to be regarded as accruing only when it is realised. On the same reasoning, it might be held that at least part of the profit of a trader has been earned when the goods are purchased. In certain circumstances, it may demand more skill to buy goods on favourable terms than to sell them. Nevertheless, the auditor must be guided by the principles which command general acceptance, and should accept a valuation of stock or work in progress above cost only when such a valuation is sanctioned by custom and convention.

The Recommendations on Accounting Principles, while avoiding specific approval of any valuation of stock or work in progress above cost, comment on the practices above referred to in the following terms:

'In certain businesses, such as tea or rubber-producing companies and some mining companies, there is a general custom to value stocks of products at the price subsequently realised less only selling costs; if this basis is adopted, the fact should be clearly indicated in the accounts.

'In the case of long-term contracts, the value placed on work in progress should have regard to the terms and duration of the contracts. If, after providing for all known contingencies, credit is taken for part of the ultimate profit, this fact should be indicated.'

The interpretation of the term 'cost' must now be considered.

In the case of a merchant the cost of the stock-in-trade may be taken to be the purchase price of the goods; this may be applied also to a manufacturer's stock of raw materials. In both these cases,

however, the calculation is affected by the method adopted in regard to the identification of the goods in stock. This matter is considered below.

In the case of a manufacturer's stock of finished or partly-finished goods, the term 'cost' may be interpreted in several ways. The cost of manufactured goods or processed stock will include the cost of the raw materials, direct labour and expenses, and will also normally include an addition in respect of indirect or overhead expenditure, which may be calculated in various ways. In some cases, processed stock is valued at prime cost, without any addition for overhead expenses. This cannot be regarded as a satisfactory method, since it is a fact that overhead expenses are necessarily incurred in carrying on the productive side of the business. A common practice is to value processed stock at prime cost plus an addition for works or factory overhead expenses, but excluding administration, selling and distribution expenses.

If the total of the factory overhead expenses is allocated to the output of the period, the amount allocated to each unit of output will vary with the volume of output. If output is high, the cost per unit, ascertained in this way, will be relatively low, and, if output is low, the cost per unit will be calculated at a relatively high figure. The valuation of stock becomes dependent on the volume of output. This method of valuing stock cannot be regarded as entirely satisfactory and the alternative method of valuing stock at a standard cost has been adopted in many cases. Standard cost is a predetermined or budgeted cost and the stock is valued at current cost of materials and labour with an addition for overhead expense which is based upon a normal volume of production. If the output of the period is below normal, the addition to each unit in respect of overhead expense will not be sufficient to absorb the total overhead expense of the period. It is claimed that such unabsorbed overhead expense represents the cost of idle capacity rather than part of the cost of the actual production. In this way, the cost of production and the valuation of stock are made independent of fluctuations in the volume of production. In paragraph 117 of the Recommendations on Accounting Principles, it is remarked that this basis of stock valuation 'is coming more into use, particularly in manufacturing or processing industries where several operations are involved or where goods are produced on mass production lines'.

As indicated above, the ascertainment of the cost of a merchant's stock-in-trade is affected by the problem of identifying the goods of which the stock is composed. This is equally true of the cost of the processed stock of manufacturers where the standard cost system is not employed. There are three interpretations of cost which are in common use. They are described in paragraphs 113 to 115 of the Recommendations on Accounting Principles in the following terms:

'(1) "Unit" cost.

'Upon this basis, each article, batch or parcel is valued at its individual cost.

'In certain cases, such as bulk stocks, this method is not always capable of application and records, including the allocation of expenses, may become unduly

complicated. Further, it may not be practicable to apply the method to partly processed stocks or finished products where the individual units lose their identity.

'(2) "First in, first out".'

'This basis assumes that goods sold or consumed were those which had been longest on hand and that the quantity held in stock represents the latest purchases. It has the effect of valuing unsold stock in a reasonably close relation to replacement price. In certain manufacturing or producing businesses, however, it is difficult to apply accurately through the various stages of manufacture or production.'

'(3) "Average" cost.'

'This basis entails averaging the book value of stock at the commencement of a period with the cost of goods added during the period after deducting consumption at the average price, the periodical rests for calculating the average being as frequent as possible having regard to the nature of the business.'

'It has the effect of smoothing out distortion of results arising from excessive, and often fortuitous, fluctuations in purchase price and production costs and is particularly suitable to manufacturing businesses where several processes are involved.'

It will be seen that the first method assumes that it is possible to identify the goods which are in stock and to find the purchase price actually paid for those goods.

In methods (2) and (3) there is no attempt at physical identification. In place of actual identification, it is assumed, in method (2), that the goods in stock represent the most recent purchases and, in method (3), that the goods in stock are a representative cross-section of the stock at the commencement of the period plus purchases during the period.

Under the above three methods, stock is valued, subject to certain assumptions as to the identity of the goods, at actual historical cost.

There is another method, known as 'Last in, first out', or, from the initials of this phrase, as 'Lifo', which must now be considered. Under this method, the goods sold or consumed are assumed to represent the most recent purchases, and the stock of goods to represent the earliest purchases of their kind. This assumption is clearly at variance with physical facts. Those who advocate this method do not claim, however, that the stock represents, as a matter of physical fact, the earliest purchases. It is claimed that in times of rising price levels, the illusory money profit, which is due to the rise in prices, should be eliminated from the accounts. Some of the arguments put forward by those who reason on these lines have been considered at the beginning of this chapter.

Under the Lifo method, revenue account is charged with an amount which approximates more closely to the current replacement price of the goods than does the amount charged to revenue under, for example, the first in, first out (or Fifo) method. It is claimed that, under the Lifo method, the profit shown by the revenue account excludes, at least in part, that element which is due solely to the upward trend of prices, and which would form part of the profit that would be shown by more orthodox methods of accounting.

The Lifo method is mentioned briefly in the Recommendations on Accounting Principles and is dismissed with the comment that it is very little used in this country. Another method, differing very little

in principle from the Lifo method, is the 'base stock' method, by which a fixed volume of stock is retained at a fixed price, in much the same way as a fixed asset. The Lifo method is more widely used in the United States of America, and in that country its use is accepted in relation to the computation of profits for purposes of taxation.

The arguments for and against the Lifo and base stock methods are essentially those which are put forward in regard to the problem of the adaptation of accounting methods so as to take account of changes in the value of money. It has already been observed that the weight of opinion in this country is at present opposed to any drastic modification of customary methods. It is also pointed out that, under the Lifo method, the stock appears in the balance sheet at a figure which bears no relation either to its historical cost or to its replacement cost or to its realisable value.

Quite apart from the various interpretations of 'cost' or 'market value', the formula 'cost or lower market value' can be applied in two ways. The lower of aggregate cost or aggregate market value may be taken, or alternatively, the lower figure may be taken for each item or group of items in the inventory. If the latter alternative is adopted, it may be found that, in some instances, cost is the lower, and that, in other instances, market value is the lower.

Whatever method of stock valuation is adopted, consistency in the use of the method is of the utmost importance. The need for consistency is emphasised in the Recommendations on Accounting Principles in the following terms:

'Whatever basis is adopted for ascertaining cost or calculating market value, it should be such as will not distort the view of the real trend of trading results, and should be applied consistently regardless of the amount of profits available or losses sustained.'

✓ VERIFYING EXISTENCE OF ASSETS. Having settled a basis of valuation, the next thing would appear to be to obtain evidence of the existence of the assets enumerated in the balance sheet. It need hardly be stated that this process is entirely different from vouching the purchase or acquisition of the relative assets. The latter process establishes the price at which the asset enters the books. Verification on the other hand, is directed to proving that the asset acquired remains actually in the ownership and (usually) possession of the client.

The evidence necessary in each class of assets would be as follows:

✓ LAND AND BUILDINGS. The title deeds of the property. Should the property be mortgaged the title deeds will, of course, be in the possession of the mortgagee, and an acknowledgment of this fact should be obtained from him or his solicitor, together with a statement of the amount due. Conversely, the verification of an asset represented by a mortgage is the production of the title deeds and the mortgage deed. In the case of a second mortgage the title deeds will, however, be in the custody of the first mortgagee, and here the auditor will require to satisfy himself that such first mortgagee has received proper notice of the existence of a second charge.

Title deeds are sometimes in the hands of solicitors or bankers. This *per se* is no reason why they should not be produced to the auditor. In these cases it is essential to obtain the custodian's written declaration on the point whether the deeds are held for safe custody only, or in connection with a charge. When the title deeds are abroad, and there is no local audit, the certificate of the solicitor or banker must perforce be accepted. In that case, however, the facts should be stated in the auditor's report.

It is well known that under the law of England the title to land is surrounded by technicalities and the question is sometimes raised whether an auditor is expected to ascertain that the title, of which the documents produced are the evidence, is good. It is confidently submitted that in the absence of special instructions there is no such duty; and it seems equally certain that if special instructions are given the auditor will be careful to employ competent legal assistance. In ordinary circumstances the standard of duty required is that of the reasonably careful and competent professional auditor who is *not* expected to be a legal expert. This being so, it seems sufficient to be sure that there is a document apparently correctly executed and stamped in the form of a conveyance into the name of the party claiming title. Obviously, in a case of reasonable doubt, it is the duty of the auditor to require that he be given the assistance of the client's legal adviser.

PLANT, MACHINERY, FIXTURES, &c. There is perhaps, too much tendency to assume the correctness of the 'book' figures with regard to these assets, provided reasonable provision has been made for depreciation; it is important, however, to make careful inquiries into all additions, with a view to seeing that they represent bona fide capital expenditure that may properly be added to the value of the asset, and, further, to make particular inquiry as to the sale of worn out or discarded assets. It not infrequently happens that such sales are erroneously credited to sales account, with the result not only that a grave error of principle is committed but that due inquiry into the loss in respect of such sales is overlooked. The amount realised on the sale of fixed assets should, of course, be credited to the real account standing in the books in respect of such assets; but the realisation affords an opportunity of inquiring into the value at which these assets stood in the books, and should they have been sold at a loss, that loss must in all cases be written off, as otherwise an item will be brought into the balance sheet as an asset which represents something no longer in existence. It should not be forgotten that such ledger accounts as these are really total accounts, and that they require as much verifying as any other total account—e.g. book debts.

Occasionally, as has already been stated, a revaluation will be made for the purpose of assessing, or of checking, the provision for depreciation; but in any case a certificate should be forthcoming, to the effect that the various items included in the last inventory are still the property of the undertaking.

There can be no question that the ideal method of keeping track of

items of plant and machinery is to set up an inventory in the form of a register of plant, i.e. a series of modified ledger accounts. An account herein should be allocated to each unit of plant and full particulars of the acquisition and history thereof can be given. Not the least of the advantages of this plan is that the amount of depreciation allowed can be set against *each item* of the equipment, so that its total sufficiency can be scientifically judged. It will be clear to all accountants that under such a scheme, plant and machinery account, repairs account and depreciation account become 'controlling accounts' of the respective columns in the register of plant in accordance with the sectional balancing principle.

✓ **INVESTMENTS IN STOCKS AND SHARES:** The auditor will require to have produced to him the scrip, certificate, bond, or other document, proving that the ownership of the investment in question is vested in his clients. The broker's contract note is, of course, evidence of the original transaction only and it has no bearing on the state of the present holding.

Under British practice there are three cases in relation to which this subject must be studied, viz. (a) registered shares and stock; (b) inscribed stock; and (c) bearer bonds.

The precise nature of the title to registered holdings can best be understood by referring to Sections 26 (2) and 81 of the Companies Act, 1948. It will be seen that in law the root of the title is the entry of the holder's name on the company's register of members and that it is quite independent of the issue of a certificate. The certificate is, however, under the later section, to be taken as *prima facie* evidence of title and accordingly the auditor may accept production of this. He should see that the name corresponds with that of his client, that the number of shares is in order and that the amount paid up on each share corresponds with the record in the books of the client. Where the certificate is lost recourse may be had to inquiry of the company concerned as to the entry in its register.

In the case of Consols and other inscribed stocks no such certificate of ownership is provided, and proprietorship depends, in terms of the prospectus of the original loan, on entry in the books kept by the issuing bank or financial house. In these cases it therefore becomes necessary to obtain a certificate that, upon the date of the balance sheet, such stock stood registered (or inscribed) in the names of the auditor's clients. It is important to notice the *date* to which the certificate relates, as it is not in itself a proof of ownership, but merely a record dealing with that particular date alone, and it differs from an ordinary certificate, or scrip, in that, in the event of a subsequent sale, it does not have to be given up. Investments on behalf of a company sometimes stand in the names of individuals, who hold them in trust for the company. A proper declaration of trust, duly executed, should in all cases be produced to the auditor, or, in the case of registered investments, a transfer form signed in blank should be attached to the certificate, both documents being in possession of the client.

The important subject of investments in 'subsidiary' companies

is dealt with later in this book; but it must be stated that verification of title in such cases does not differ in principle from what is stated above.

Investment scrip deposited as security might be taken on the certificate of responsible persons, provided the deposit is itself clearly regular.

It may be added that if, when examined, the securities are securely sealed up in packages, it is often not thought necessary at subsequent audits to re-examine them in detail, if the seals remain unbroken. A caution uttered when discussing the accounts of building societies must, however, be repeated here.

The question whether the certificate of a custodian to the effect that he holds certain securities for safe custody can be accepted without personal inspection of the documents has been much debated. It was one of the central points in the *City Equitable* case (*vide* Appendix B) in 1924. The judgment of the Master of the Rolls in the Court of Appeal on this point is of the greatest possible importance and it should be read *in extenso*. The words used, as summing up the whole effect of the judgment, were:

'I think he must take a certificate from a person who is in the habit of dealing with, and holding, securities, and who he, on reasonable grounds, rightly believes to be, in the exercise of the best judgment, a trustworthy person to give such a certificate. Therefore I by no means derogate from the responsibility of the auditor, I rather throw a greater burden upon him, but at the same time, I throw a burden upon him in respect of which the test of common sense can be applied, and common habit can be applied, rather than a rigid rule which is not based upon any principle either of business or common sense.'

These words seem to endorse what has always been the professional practice, i.e. to accept the certificate of a recognised banking institution; but as was shown in the *City Equitable* case, auditors occasionally, and in special cases, accept the certificate of such an institution as a stockbroking house. It is quite clear, however, that in all cases omission to make personal inspection must be practised with care, and it is suggested that 'care' means that there must be no ground for suspicion, that the custodian must be a person whose ordinary business is to hold securities and that they must be handed to such person in the ordinary course of the owner's business.

It need hardly be added that a mere receipt for a deposit is not enough; there must be a clear certificate as at the date of the balance sheet.

TAX RESERVE CERTIFICATES. The auditor should inspect the tax reserve certificates and should see that the name corresponds with that of his client.

Tax reserve certificates should be grouped in the balance sheet with the current assets. It is recommended by the Institute of Chartered Accountants that the interest allowed on the surrender of the certificates in payment of taxation should be treated as interest and not as a reduction of the taxation charge. It is also suggested that the accrued interest to the date of the balance sheet should not be taken to credit

unless the certificates have been surrendered before the balance sheet has been signed.

STOCK-IN-TRADE. The original stock sheets, signed by the stocktaker, calculator, checker and manager must be examined. Most accountants, would, in addition, consider it essential that the more important extensions and additions be checked by one of their own staff (not forgetting the summarisation) and, further, would require to be satisfied as to the soundness of the system of valuation adopted.

It would be a mistake to suppose that the duty of an auditor is sufficiently discharged by the bland acceptance of certified stock sheets presented to him. It is necessary in addition that he should subject them to an intelligent scrutiny with a view to applying any tests which may possibly apply to the particular case in hand. Some stock is of so miscellaneous a character that it would hardly be practicable for the auditor to detect any omission or inflation. On the other hand, in the case of dealers in articles which are readily identifiable it is often possible by comparing the previous stock with the recorded purchases and sales to determine with precision the number and identity of the articles which should be in stock. Such a case would be that of a dealer in motor-cars, and in this connection a reading of the case *Colmer v. Merrett, Son and Street* reported in Appendix B is very instructive, especially when it is compared with *Henry Squire (Cash Chemist) Ltd. v. Ball, Baker & Co.*, which occurred at a slightly earlier date.

A comparison of the stock sheets with the later portions of the purchase journal and goods inwards book is an important part of the auditor's examination, for not only will this process sometimes suggest irregularities in the quantities recorded in the stock sheets, but it will also furnish an invaluable confirmation of the prices at which the several items are listed. It is also useful to compare the prices at which articles are put into stock with the prices at which corresponding articles are recorded as being sold in the early part of the following period. The difference between the two prices should be capable of reconciliation with the ratio of gross profit which the business is accustomed to earn. Where the business is such that stock accounts can be kept, it is perhaps needless to say that these accounts should be compared with the inventories of stock and that any discrepancies should be most carefully investigated.

The auditor should satisfy himself that no furniture, tools, or other assets are included in the stock sheets. If any goods are in the possession of agents, he should obtain certificates from the agents as to the quantities held, and see that these items are included. He should also see that all goods which have been sold are excluded from the stock. The record of sales for the last few weeks of the accounting period may be checked with the goods outwards book.

The legal position of auditors in regard to stock-in-trade is considered in Chapter XII.

American practice in regard to the verification of inventories has

been greatly influenced by the *McKesson and Robbins* case in 1939. In this case, fictitious inventory items amounted to \$10 million. The present American practice is stated in the following extract from *Audits by Certified Public Accountants*, published in 1950 by the American Institute of Accountants:

'The C.P.A. is required by generally accepted auditing practice to be present at the inventory-taking to observe the effectiveness of the count procedures when it is practicable and reasonable to do so, and the amount of the inventory is significant.'

/WORK IN PROGRESS. This should be certified by the works manager, the chief of cost office, and the managing director. Dealing here only with the verification of the existence of work in progress, as distinct from its valuation, it should be stated, as was said when referring to stock-in-trade, that a mere acceptance of any certified figures which may be put before him is decidedly not the correct course for any auditor to take. Figures which are *not* certified should not be taken, but that is not to say that certification is the only verification possible or desirable, other than in very exceptional cases. In this connection the report (given in Appendix B) of the case *In re the Westminster Road Construction and Engineering Co. Ltd.* (Chancery Division, 5th February, 1932), is of the greatest importance and the judgment of Mr. Justice Bennett appears to lay on auditors a higher degree of duty than that of which many of them were previously aware.

It is obviously difficult to lay down a general rule as to the steps which ought to be taken. As was made clear in the judgment referred to above, an auditor's duty 'must depend upon the facts of each particular case and must be determined by the nature of the business carried on'. It can be stated, however, that, inasmuch as every audit must necessarily to a certain extent lag behind the transactions which it reviews, much help may be gained by looking carefully at the sales or deliveries for the early part of the new period; for it stands to reason that, in the absence of explanation, work in progress should rapidly develop into a completed transaction. Similarly, there should be a reasonable relationship (according to the class of business) between the amount of the work in progress and the sales of a financial period.

Especially where the business is of the contracting class the work in progress should be capable of verification by reference to the cost accounts of the jobs; but this does not preclude the application of the other tests mentioned above.

/BOOK DEBTS. The extent to which it is practicable to verify the existence of book debts depends largely upon circumstances. Unless they are very numerous the auditor should satisfy himself that the total appearing in the balance sheet agrees with the ledger balances, and that proper provision has been made for all trade discounts and also for bad and doubtful debts. With regard to cash discounts it is not unreasonable that provision should be made. A cash discount is, no doubt, a reward for payment before the account becomes

overdue and it is therefore usually charged in the period which gets the benefit of such prompt payment. However, in some cases the full cash discount is provided on all debts appearing in the balance sheet, and the debts are thus shown at an amount which does not exceed the sum they are expected to produce. Where cash discounts are deducted from the trade creditors they must, of course, also be deducted from the trade debtors.

With regard to bad debts the main point is that the provision should be scientifically made; that is to say, that all debts known to be bad should be written off, that specific items considered to be doubtful should be provided for individually on their merits and that a percentage based on experience should be provided against the balance. A well managed office should have schedules of the overdue debts arranged in columns according to their age and the application of a 'sliding scale' percentage for the risk of bad debts is in such cases obviously indicated. Reference has already been made to the practice occasionally adopted of providing on the basis of credit sales.

The auditor should also obtain a certificate from at least one responsible person acquainted with the facts, to the effect that in his judgment due provision has been made for any loss that is reasonably likely to occur.

As the number of book debts increases it becomes impracticable for the auditor to verify the ledger balances in detail; it has already been explained, however, that, where an adequate system of internal check exists, the verification of details can to a large extent be superseded by tests. For all practical purposes it is probably as efficacious to check the balances of, say, one or two ledgers out of twenty as it would be to check the whole.

It is suggested that the following points merit attention in cases where they are likely to occur:

- (a) If debts have been incurred in a currency other than sterling, the currency receivable should be converted at the rate current on the date of the balance sheet, less due provision for any adverse movement of exchange which appears reasonably probable before the due date of the debt.
- (b) Debts due on hire purchase transactions require special treatment. This matter is dealt with later in this book.
- (c) Where debts are specifically contracted to be paid at a future date and where the computation thereof includes an element of interest, the future proportion of that interest should be deducted.
- (d) Where the debts include a charge for empties, packages, &c., great care is needed. There are three cases, viz.:
 - (i) where the package is non-returnable the charges carry a heavy risk-rate for bad debts. Many customers omit or refuse to pay and enforcement of debts of this kind is notoriously difficult;
 - (ii) where the package, if returned, is to be credited at the same amount as charged. The same risk of bad debts applies

here, with the additional factor that provision must be made in the case of debts otherwise good for the difference between the amount owed on the package and the intrinsic value thereof when returned;

- (iii) where the package, if returned, is to be credited at a figure less than that charged, there is again a risk that the total charge may become bad; and, in addition, the difference between the creditable value and the intrinsic value of those expected to be returned must be provided.

In some cases it is deemed desirable to seek confirmation from the individual debtors of the amounts due from them. One plan is to enclose a post card with the statement asking the recipient to sign in confirmation of the amount owing, or to give particulars at once of any discrepancy. A still tighter check is obtained if the debtor is asked to send these communications direct to the auditor. Some clients dislike the latter plan on the ground that it gives their customers the impression that something is wrong. It is easy to understand this objection and in any case an auditor should never communicate with a debtor without the express consent of his client. There can be no objection, however, to the auditor making sure that statements do actually reach the debtors by himself mailing them after comparison with the ledger accounts.

The American practice in this matter is stated in the following extract from *Audits by Certified Public Accountants*, published in 1950 by the American Institute of Accountants:

'Accepted practice requires the C.P.A. to obtain confirmation of a representative portion of the balances of accounts receivable by communicating with the debtors whenever practicable and reasonable, and where the aggregate amount of accounts receivable represents a significant portion of the current assets or total assets of the company.'

✓ **BILLS RECEIVABLE.** Verified by production of the actual bills themselves. Care should be taken to see that no overdue bills are included in a balance sheet under the heading of 'bills receivable'; that due provision is made for rebate of interest where necessary, especially where interest is an element in the amount of the bill, and that all anticipated loss by way of bad debts in respect of bills receivable—both in hand and under discount—is included in the accounts.

If the bills cannot be produced because they have been paid between the date of the balance sheet and the date of the audit, verification consists in tracing the resultant cash into the bank.

It may be mentioned here that the amount of all bills under discount and not yet due forms a contingent liability to be noted on the balance sheet.

✓ **BANK BALANCE.** Banker's pass book or statement, verified either by personal visit to bank or (more usually) by banker's certificate of balance, addressed direct to the auditor.

In practice it will rarely happen that the balance recorded in the pass book or statement exactly agrees with the balance in the cash

book, and, after the cash book has been completed by entry of all charges, interest, dishonoured cheques, &c., a reconciliation account has therefore to be prepared.

The traditional form of a reconciliation is on the following lines:

A.B.

BANK RECONCILIATION STATEMENT, 31ST DECEMBER, 19.....
(MIDLAND BANK LIMITED, BLANK STREET BRANCH)

Balance at bank per pass book		£1,267 1 9
Less Cheques unpaid, viz.:		
Dec. 16, Jones	£29 2 0	
„ 21, Smith	16 5 9	
„ 29, Brown	71 14 2	
		117 1 11
		1,149 19 10
Add Payments in not credited, viz:		
Dec. 30, Bill No. 69	120 0 0	
„ 31, Sundries	69 2 7	
		189 2 7
Balance at bank per cash book		£1,339 2 5

It is submitted that the form illustrated below is a distinct improvement because it accords with the familiar 'account' form of statement of facts, reduces the risk that addition and subtraction may be transposed (a form of fraud not unknown in this connection) and provides a definite reminder that the adjustments made need investigation.

A.B.

BANK RECONCILIATION ACCOUNT, 31ST DECEMBER, 19.....
(MIDLAND BANK LIMITED, BLANK STREET BRANCH)

	Amount	Date credited		Amount	Date paid
	£ s d			£ s d	
Balance at bank per pass book (certified by bank on — 19)	1,267 1 9		Balance overdrawn per pass book (certified by bank on — 19) ..	—	
Payments in not credited, viz.:			Cheques unpaid, viz.:		
Dec. 30 Bill No. 69 ..	120 0 0	1 Jan.	Dec. 16 Jones ..	29 2 0	3 Jan.
„ 31 Sundries ..	69 2 7	2 Jan.	„ 21 Smith ..	16 5 9	1 Jan.
Balance overdrawn per cash book carried down ..	—		„ 29 Brown ..	71 14 2	6 Jan.
	£ 1,456 4 4		Balance at bank per cash book carried down ..	1,339 2 5	
				£ 1,456 4 4	
Balance at bank per cash book brought down ..	1,339 2 5		Balance overdrawn per cash book brought down ..	—	

It is to be noted that this form provides a definite reminder to the audit clerk that two most important checks must on no account be omitted, viz.: (a) Uncredited deposits must be carefully followed up to see that they are actually credited in the new year; the paying-in slip should also be inspected, with its dated bank stamp, in order to make sure that the 'make-up' of the actual deposit agrees with the details in the cash book. Omission of the precaution to follow these

uncredited items actually into the bank has often resulted in failure to discover fraud until possibly the end of the ensuing year; there is even the risk that at the end of that year a fraudulent cashier may devise another false deposit to cover the matter; (b) it is desirable, in order to effect a thorough check on the reconciliation to follow up unpaid cheques and to ascertain that the date of payment thereof is after the close of the period. This is particularly important where every item in the pass book or statement is not compared with the cash book. The best plan is to call for the actual cheques and to notice their serial number, date and date of cancellation by the bank. It is possible, of course, that there may be cheques uncleared even at the date of the audit. The attention of the client should be drawn to these; they may not have been actually issued, or he may desire to communicate with the payee. Unless the cheques can be regarded as cancelled it is advisable to note them carefully for attention at next audit.

In this connection the case of *The Brighton Eden and Empire Syndicate Ltd. v. London and County Bank Ltd.* (decided in 1904) will be found of interest. This was an action brought against the defendant bank for damages for loss sustained through the negligence of their manager in allowing the manager of the plaintiffs himself to make entries in the bank pass book, which entries were, it was stated, inaccurate in point of date although accurate as to amount. By this means the plaintiffs' manager was able for a number of months to avoid detection at the monthly audit of his accounts, and at the end of the year, when the defendant bank were called upon to certify the balance shown in their pass book, the deficiency was made good, doubtless, by the plaintiffs' manager temporarily borrowing the amount of his defalcations. The decision in this case, that the defendant bank were liable in damages, is satisfactory to auditors, in that it makes a pass book duly obtained from a bank a reliable basis for the auditor's verification, whether formally certified as correct or not.

✓ **CASH IN HAND.** Verified by production of actual cash balance, or, if the date of the accounts has gone by, by exhaustively vouching the cash account up to the date of audit and *then* counting the balance of cash in hand. In cases where there is more than one cash till, all must be produced to the auditor and verified by him simultaneously; but, wherever practicable, it is preferable that all (or nearly all) cash in hand should be paid into the bank on the afternoon of the date of the balance sheet, in which case, of course, the verification of cash is reduced to small dimensions, or disappears. In the case of cash at distant branches a satisfactory certificate that the balance exists may generally be accepted in lieu of actual counting. In continuous audits all cash balances should be frequently counted—say, at least once a month.

In the case of *London Oil Storage Co. Ltd. v. Seear, Hasluck & Co.* (*vide* Appendix B) an unsuccessful attempt was made to plead that it was not part of an auditor's duty to verify the balance of petty cash in hand. This might fairly be conceded if the balance of petty

cash did not exceed a small limit, but in the case in question the petty cash book showed a balance which had gradually increased from £21 in 1897 to £796 in 1902. And whatever may be said in general terms, therefore, as to the desirability of an auditor verifying balances of cash in hand, it is clear that it would be only prudent to regard the existence of a large floating balance as *prima facie* a matter for suspicion, and therefore a matter calling for careful inquiry; and this was the view taken by the jury in this case, although they awarded the plaintiffs nominal damages only.

APPORTIONMENT OF EXPENSES AND INCOME. The principle that each year's revenue account should contain only those expenses and incomes relating to that year's operations reacts on the balance sheet by causing to appear therein unexpired expenditures and incomes in arrear as assets, and expenditures in arrear and incomes received in advance as liabilities. It is always desirable that careful apportionment be made of the relative items and that sheets should be preserved in the audit papers showing exact details of the calculations. Some book-keepers exhibit a tendency to insert round sums into the books under this head, as being 'about right' or 'on the safe side', but experience shows that such inexact methods are dangerous.

It is the almost invariable modern method to carry down these apportionments as balances on the relative nominal accounts; there can be no objection, however, to carrying them to a special suspense account, the entry being reversed as on the first day of the new year. In such case, however, the distinction between credit and debit balances, liabilities and assets must be preserved. It is never correct to state a net figure in the balance sheet.

All expense accounts, e.g. wages and salaries, should be examined carefully, to make sure—as far as possible—that no outstanding liabilities have been omitted.

The auditor's own fee should not be overlooked. It is generally conceded that this should be borne by the period which is audited; and in cases where the fee is not fixed in advance a reasonable estimate should be inserted.

The minute book may disclose the existence of liabilities, both certain and contingent, that are not recorded in the books of account.

CONTINGENT LIABILITIES must not be forgotten. Bills discounted are perhaps the most usual source of contingent liability. Contingent liabilities under all kinds of guarantees are important, unless trifling in amount. Disputed claims must not be lost sight of however; and claims for dilapidations on premises, the lease of which has almost expired, should be anticipated, so that the whole loss may not fall upon one year. Arrears of cumulative preference dividends also come under this heading on the principle that, although no right to receive dividend arises until the declaration thereof, yet a person considering taking up an ordinary share is clearly entitled to be informed that there is this prior call on future profits.

GOODS ACQUIRED ON HIRE-PURCHASE TERMS. From the auditor's point of view the main point of importance is to see that a correct system of dealing with the transactions is adopted, i.e. one which charges a sufficient proportion of the instalments against the revenue of each year, so as to avoid the proportion capitalised appearing at too high a figure. This is a pure question of interest calculations, and the following table will suffice to show the present value of the unpaid instalments upon any hire-purchase agreement for the acquiring of railway wagons.*

**TABLE SHOWING PRESENT VALUE OF PAYMENTS UNDER
HIRE-PURCHASE AGREEMENTS**

Instalments: £100 per annum	At 5 per cent. Yearly Rests	At 5 per cent. Half-Yearly Rests	At 6 per cent. Yearly Rests	At 6 per cent. Half-Yearly Rests
	£	£	£	£
Agreement with 1 year to run	95·238	96·371	94·340	95·673
" 2 "	185·941	188·098	183·339	185·855
" 3 "	272·325	275·406	267·301	270·859
" 4 "	354·595	358·507	346·511	350·984
" 5 "	432·948	437·603	421·236	426·510
" 6 "	507·569	512·888	491·732	497·700
" 7 "	578·637	584·545	558·238	564·803
" 8 "	646·321	652·750	620·979	628·055
" 9 "	710·782	717·668	680·169	687·675
" 10 "	772·173	779·458	736·009	743·874

The amount charged against revenue must be equal to the interest on the present value of the instalments due at the commencement of that period, and the apportionment must be so arranged that when the agreement expires the proportion that has been capitalised does not exceed the present value of the instalments at the date of the commencement of the agreement; putting the matter another way, the asset account must ultimately stand debited with a figure not greater than the original cash price. All repairs must, of course, have been charged to revenue, and some further provision must be made for depreciation, based, needless to say, on the initial cash value. This, however, may be more conveniently discussed under that heading.

The most convenient book-keeping arrangement is to bring the initial cash price on to the asset account at once, while raising a liability in respect of the capital portion of future instalments. The instalments payable may then be passed through the purchase journal, like any other invoice, being analysed there for debit either to interest or to the capital liability account mentioned. On the balance sheet the usual plan is to describe the asset as 'interest in goods being acquired by hire-purchase' and to assign as a value the (depreciated) difference between cash price and future capital instalments.

The above remarks apply in their entirety to hire-purchase agreements for the acquiring of railway wagons and any other articles which are ordinarily purchased upon such terms. At the present time, however, cases frequently occur in which furniture, musical instruments, bicycles, &c., are sold under hire-purchase agreements, and in these cases the rate of interest charged is almost invariably far

* In cases where a reference to Tables is impracticable the auditor will be upon the safe side if he reckons the cash value as being the aggregate amount of the instalments minus simple interest thereon, at the prescribed rate, for half the prescribed period.

higher, usually varying from 10 per cent. to 30 per cent. per annum on the unpaid instalments. The proper treatment of these transactions is fully considered in the author's *Advanced Accounting*: for present purposes it will be sufficient to point out that firms transacting business of this description usually deal with a very large number of items, each of comparatively small amount. It consequently follows (1) that it is impracticable to keep such intricate accounts as would be necessary accurately to apportion every instalment received between interest and capital; (2) that such scrupulous exactness is unnecessary in practice, as the volume of the transactions is sufficient to enable an *average* to produce fairly reliable results. The best principle, therefore, is to regard the difference between the cash price and the credit price of the articles sold as interest charged, and having ascertained the average rate of interest to apportion it between the three years over which the currency of these agreements almost invariably runs. By this means practically accurate results can be obtained with a very small expenditure of labour. The apportionment should, however, be in favour of the later years, so as to err upon the side of caution, and it may be added that due provision for bad debts and lapses will here require special consideration. A useful guiding principle in the latter respect is the fact that the amount taken as the debt under any hire-purchase agreement should not exceed the intrinsic value of the goods which might be returned in cancellation thereof.

✓ **PROVISION FOR BAD AND DOUBTFUL DEBTS.** Unless the outstanding book debts are extremely numerous, it is desirable that the auditor should go over the list in company with his client, or the managing director, or some equally responsible authority, and settle the amount of loss to be provided for. Where the number of accounts renders this course impracticable, a certified list of amounts to be treated as bad, and a statement that the provision made is sufficient, signed by the aforesaid responsible authority, should be supplied to the auditor. It is not intended to suggest that, merely because the auditor has been supplied with a certified list of the provisions which it is thought necessary to make for bad and doubtful debts, all he has to do is to accept it without further comment or inquiry. It, of course, remains for the auditor to satisfy *himself* that the provision is one which appears to be both bona fide and reasonable.

In this connection some stress should be laid on the opportunity which the auditor has to exercise trained intelligence in the scrutiny of personal ledger accounts. For example, where debtors appear to be in the habit of paying sums on account which do not effectively reduce the balance at debit, suspicion is immediately thrown on the soundness of the debt. In ordinary cases the accounts of debtors should be balanced down to definite points and if it is found that old balances are left unsettled while later ones are paid, there is *prima facie* evidence either of a disputed amount or of the fact that the debtor has stopped payment and has later resumed business under an arrangement. Debts which consist of debits in respect of dishonoured cheques or bills are obviously to be regarded with grave suspicion.

It may be added that, in most cases, there should be a fairly constant ratio between the amount of outstanding book debts and the total of the sales on credit during (say) the last three months.

The reader is reminded of the recommendations made in an earlier part of this work for the transfer to a special ledger of debts which have become doubtful.

Some book-keepers have an inaccurate habit of treating their bill books as memoranda only, so that debts for which bills have, in fact, been given remain on the personal ledger account of the acceptor. This is perhaps the place to condemn this practice and to warn the auditor that the inclusion of bills receivable amongst 'sundry debtors' is a breach of good practice.

In connection with the duties of auditors in relation to bad debts the judgments in the *Irish Woollen Co.* and the *National Bank of Wales* cases (*vide* Appendix B) will be found of interest. See also the *Scarborough Harbour* case discussed in Chapter XII.

DIRECTORS' FEES. In the absence of any special arrangement contained either in the articles of association or in the minutes of general meeting, directors are entitled to no remuneration in respect of their services. The auditor will require to see, therefore, before passing any such remuneration, that provision is contained therefor in the articles of association; or else that the remuneration has been voted by the shareholders in general meeting. He will also require to see that the amount which the directors have received is in accordance with such provisions. Proper vouchers should be given by directors for fees received by them.

In the absence of special provision a director is not entitled to be repaid his expenses of attending board meetings in addition to his remuneration. When the remuneration provided is simply a stated sum *per annum*, directors who serve for part of a year are not entitled to an apportioned part thereof. For this reason remuneration is often granted as 'at the rate of' a certain sum *per annum* or is expressly stated to accrue from day to day. In any event, however, in considering outstanding liabilities to be brought into the balance sheet it is only reasonable to assume that the year will be completed, and that therefore the fee will be earned.

The case sometimes arises, in connection with companies which are not doing very well, of directors forgoing the whole or a portion of their fees. In such a case as this it is desirable that the auditor should inquire whether they have actually forgone the right to claim such fees, or merely forgone their immediate payment. In the latter case the amount still due should, of course, be included among the liabilities in the balance sheet. It is, perhaps, superfluous to add that no one who is not a director can be entitled to receive directors' fees. As the Companies Act requires every company to keep a register of its directors and managers, it seems desirable that this register should be consulted when vouching the payments made, or due, to directors in respect of fees.

Where remuneration takes the form of a commission based on

distributable profits, the articles may provide that the commission is to be calculated as a percentage of the profits remaining after the commission has been charged, so that e.g. 5 per cent. is only one twenty-first part of the profits otherwise arising. If the articles do not provide that the commission itself is to be deducted in arriving at the profits upon which the commission is to be based, the commission must be calculated on the amount of the profits before deducting the commission. Thus, it was held in the case of *Edwards v. Saunton Hotel Co. Ltd.* ([1943] 1 All E.R. 176) that the commission of a director who was entitled to 20 per cent. on the sum available for distribution by the company at the end of each year should be calculated on the profits before deducting the commission. It was also held in this case that depreciation of fixed assets should be deducted in ascertaining the profits, but that income-tax should not be deducted.

Section 189 of the Companies Act, 1948, prohibits the payment of directors' remuneration free of income-tax or in any way calculated by reference to income-tax. This section does not apply to remuneration under a contract which was in force on 18th July, 1945, and which expressly provides for such remuneration. Subject to the important exceptions mentioned below a director of a company must, by Section 185 of the Companies Act, 1948, vacate his office at the conclusion of the annual general meeting next after he has reached the age of 70, and no person may be appointed a director after attaining that age. But, if the appointment of a director over 70 years of age is made or approved by a company in general meeting, then, provided special notice of the resolution of appointment or approval has been given, such a director may hold office. This section is subject, in the case of a company registered after 1st January, 1947, to the company's articles, and, in the case of a company registered at an earlier date, to any alteration of the articles made after 1st January, 1947. The section does not apply to private companies, apart from certain subsidiary companies.

INCOME TAX. It has been recommended by the Council of the Institute of Chartered Accountants that the charge in the profit and loss account for income-tax should be based on the profits earned during the period covered by the accounts. This matter is considered in Chapter VIII.

The Recommendations on Accounting Principles also include the following:

'(1) Revenue taxed before receipt.

'Income-tax on revenue taxed before receipt should be included as part of the taxation charge for the year and the relative income should be brought to credit gross.

'(2) Dividends payable.

'It is pointed out that the payment of a dividend to shareholders does not affect the amount of tax payable by a company, the assessment being on the amount of the profit as adjusted for the purposes of income-tax.

'It is recommended that, whether dividends are described "less income-tax" or "free of income-tax", the amounts shown in respect thereof in the accounts should be the net amounts payable.

'(3) Annual charges.

'It is observed that, on the other hand, income-tax deducted upon payment of debenture and other interest, royalties and similar annual charges is in effect assessed upon a company for collection from the payee.

'It is recommended that annual charges for debenture and other interest, royalties and similar annual payments should be charged in the accounts gross.'

PRELIMINARY EXPENSES. In the balance sheet of almost every young company this item will be found among the assets. It will probably surprise few to learn that, as the law is at present interpreted, registered companies are under no obligation to write off this item out of profits. It is, however, not only very desirable, but also very usual to write off the amount of the preliminary expenses within the first three or five years; and the auditor will do well to recommend the adoption of such a course. The preliminary expenses of parliamentary companies, on the other hand, are an item of capital expenditure, and, as such, are retained upon the accounts for ever.

It goes without saying that, in every case, the auditor must thoroughly verify the amount of this item by reference to vouchers and contracts. In particular, he should make sure that the company has made no payments that the promoters undertook to pay, or which—for other reasons—may appear improper. It is not an unknown occurrence for directors' qualifications to be paid for out of preliminary expenses; the impropriety of such procedure need hardly be stressed.

INSPECTION OF MINUTE BOOK. It is desirable that the auditor should examine the whole of the contents of the minute book, for not only are the whole proceedings of the company validated by the authority recorded in this book, but entries therein may bring to the notice of the auditor matters which may profoundly affect the report he must make to the members. If an auditor is refused facilities for performing his duties, and such refusal takes the form of declining to allow him access to any of the 'books, accounts and vouchers of the company' (*vide* Companies Act, 1948, Section 162 (3)), or if the directors or officers of the company fail to give such information and explanation as may be necessary, the auditor must state in his report that he has not obtained all the information and explanations necessary for the purposes of his audit.

REDEEMABLE DEBENTURES. Where debentures redeemable at par or at a premium have been issued at a lower price, it is essential that the discount on issue should be written off over the life of the debentures and that revenue should be charged with an amount sufficient to meet the premium; and it will be the auditor's duty to see that this is done. With regard to the repayment of the capital of the debentures, it is not in *all* cases necessary that profits should be set aside. 'Circumstances alter cases' and it may well happen that the necessary finance may be in sight in another direction; but apart from this it is obviously necessary that financial arrangements of some kind should be made and where debentures are redeemable at a definite date it is usually the auditor's duty to see that arrangements for repayment are made.

FORFEITED SHARES, not reissued, should be stated separately on the balance sheet, to the extent of the cash received thereon, as a dividend declared would not be payable in respect thereof. It must be remembered that the power to forfeit arises from articles and not from statute and that forfeiture does not cancel the holder's liability to pay calls due at the time thereof; consequently the auditor should always make a point of seeing that the minutes as to forfeiture and as to the calls due are *prima facie* in order.

FOREIGN EXCHANGES. The treatment of foreign exchanges in books of account appertains to book-keeping rather than auditing, and the subject will accordingly be found to be fully dealt with in the author's *Advanced Accounting*. From the point of view of the auditor, it is necessary that the accounts should properly disclose the true position of affairs. For this purpose it is necessary to bear in mind that the trial balance (from which the accounts are compiled) is a summary of *transactions* that have actually taken place, temporarily recorded, for the sake of convenience, in the medium of a foreign currency. To determine their proper valuation in sterling it is necessary that the nature of these various records should be inquired into; that the revenue account (whatever its precise form) should correctly show, under suitable headings, the totals of the various kinds of transactions on account of revenue, converted at the rates ruling when the transactions took place, i.e. (usually) at average rates computed over short periods; and that the balance sheet should fairly state the assets and liabilities—those of a current nature at their realisable cash value, measured in sterling, while the fixed or permanent items may be maintained at the original amount, subject only to such provision for depreciation (converted at the same rate of exchange as is applied to the corresponding assets) as may be necessary in view of their wasting character. Actual conversions of cash from one currency to another are matters of fact and do not require the application of any theoretical principles of conversion. The problem of converting assets and liabilities has, however, been made a very difficult one by reason of the complicated currency and exchange restrictions which are in force to-day in so many countries. Current assets in unrestricted currencies may be converted into sterling at the rate ruling on the date of the balance sheet, but, in the case of currencies subject to restrictions, it will be prudent to take a lower rate. Where political conditions are uncertain, the value of assets held in foreign currencies may be very uncertain indeed, and it may sometimes be prudent to attach no sterling value to them at all.

ULTRA VIRES. It is a question of some nicety how far an auditor is expected to concern himself with the power of the company to enter into the transactions coming under his notice. It may be taken that, in general, the auditor is not constituted a judge of the conduct of the directors in their administrative capacity; and that, so long as the accounts are in order, and in accordance with such statutory provisions as may affect the particular undertaking, and its mem-

orandum or articles of association (or their equivalent), the auditor need not concern himself with questions which his professional training has not especially qualified him to solve. It is clear, however, that when the auditor is aware that irregularities have been committed, it becomes his duty to report the whole circumstances to the shareholders (cf. decisions in the *Birmingham Small Arms* case and *Re Republic of Bolivia Exploration Syndicate*, reported in Appendix B).

Practically, however, the auditor, not being a lawyer, will not be responsible for failure to detect irregularities of this description which have not come to his notice, and which he has not failed to detect by reason of his negligence or absence of proper care or skill (legal skill not being expected). It will thus be seen that the statement that an auditor is not concerned with questions of *ultra vires* is true only so far as the lowest ground is taken of the bare limits of the legal responsibility of the auditor, and that he who desires to make his audit as efficient as possible will, so far as his knowledge permits, give due consideration to this as to all other questions.

It must be remembered, however, that in most cases there is a much greater probability that the *directors* will enter into transactions which are *ultra vires* themselves than that the company itself will travel outside the limits of its own memorandum of association. There is a correspondingly greater responsibility on the part of the auditor to detect such irregularities. The directors must act strictly within the terms of their appointment and within the articles of association. The authorities state that all directors are 'fiduciary donees of their powers', an expression which goes as nearly as possible to saying that they are trustees, without throwing on them the whole of the legal responsibilities of trustees. The expression means that the directors 'are bound to exercise their powers so as not to give themselves an advantage over other shareholders'. One of the most frequently misunderstood results of this principle is that a director is precluded from contracting on behalf of the company with himself in a matter where his personal interest conflicts with the interest of those to whom he is bound by his fiduciary duty. In most cases the application of this rule is relaxed by articles of association allowing such contracts, provided that the interest of the director is disclosed to the board and that the director concerned does not vote. The duty to disclose is statutory under Section 199 of the Companies Act, 1948. The principle goes so far that it has been stated (on the authority of an Irish decision) that even the issue by directors of debentures to themselves, as security for money advanced, falls within the rule. The terms of the articles and of the Act must obviously be complied with strictly, and disclosure of such interest must be made not merely to other directors who are equally interested in the contracts in question, but to directors who are really independent. In the absence of an article which authorises a director so to contract with the company, the contract cannot be made even by the votes of the directors not interested; this curious result arises from the old principle that the company has a right to the unbiased opinion of the whole board.

CHAPTER VIII

FORM AND CONTENT OF ACCOUNTS AND BALANCE SHEETS: THE REQUIREMENTS OF THE COMPANIES ACT, 1948

IN a strict view of auditing, the function of an auditor is to audit accounts, already prepared, which are laid before him; hence, subject to exceptions to be mentioned, he is not concerned with the particular form in which those accounts are cast. Yet, in fact, auditors are frequently asked to settle questions of form and, in any case, it cannot be denied that the subject is at all times one on which the auditor should have definite and well-matured opinions.

It may be stated at the outset that the accounts which it is now proposed to deal with are those which are ordinarily published as 'the audited accounts'—viz. the profit and loss account and the balance sheet.

In the case of the sole trader, the only matter with which the auditor *qua* auditor need concern himself is to see that the accounts as finally signed contain nothing calculated to mislead the reader into whose hands the accounts may come. A similar remark applies to partnerships except that, here, the account ought to be so drawn up as to accord with any special requirements of the partnership agreement and so as to enable each partner properly to appreciate his rights in the partnership property and profits.

The case of companies, on the other hand, stands on an entirely different footing. In particular, the Companies Act, 1948, has had a very profound and far-reaching effect on the form and content of the accounts of companies.

DISCLOSURE IN COMPANY ACCOUNTS: SECRET RESERVES.

It is not too much to say that in less than twenty years there has been a revolution in accounting thought and practice in regard to disclosure in the published accounts of companies, and the Act of 1948 is the consequence rather than the cause of that revolution. In the not too distant past, it was generally held that secret reserves were often desirable and even essential, and it was believed that the concealment of profit by understatement in the balance sheet of a company's assets or by an exaggeration of its liabilities was in most cases entirely proper and in the best interests of the shareholders.

The usual object of creating secret or undisclosed reserves is to equalise dividends and apparent profits and to conceal fluctuations; in the words of the report of the Cohen Committee on Company Law Amendment, 'undisclosed reserves accumulated in past periods may be used to swell the profits in years when the company is faring badly'. The concealment of fluctuations in profits promoted, it was believed, confidence and stability, and was therefore justified. The

judgment in *Newton v. Birmingham Small Arms Co. Ltd.* lent support to the view that understatement in the balance sheet was not contrary to the law, and the report of the Wilfred Greene Committee on Company Law Amendment, and the ensuing Companies Act of 1929 appeared to surround the policy of concealment with an aura of authority.

These beliefs were violently disturbed by the occurrence of the criminal prosecution of the chairman and auditor of the Royal Mail Steam Packet Company in 1931. (The case is reported as *Rex v. Kysant and another*). The year 1931 marked a turning point in the development of opinion in regard to secret reserves and to the form and content of company accounts.

The gravamen of the charges in the *Royal Mail* case was that, at a time when the gross earnings of the shipping fleet did not suffice to cover the expenses of the company, 'special credits' were brought in so as to produce an annual surplus in the published accounts. These 'sepecial credits' were, for the most part, items provided in previous years against taxation liabilities estimated to accrue, but which became 'free', by the time the crucial years arrived, as a result of negotiations with the Inland Revenue authorities, whereby the liabilities were agreed to be very considerably less than the original estimate. Nevertheless the 'special credits' were included in an omnibus item on the credit side of the published profit and loss account, which read: 'Balance for the year, including dividends on shares in allied and other companies, adjustment of taxation reserves, less depreciation on fleet, &c., £439,212.' A transfer from reserve £150,000 was separately stated, and the Crown contended that such items in the accounts constituted 'a deliberate false representation to the shareholders that the company was making a trading profit, when in fact it was making a trading loss'. It was further submitted that 'the words beginning "balance for the year", coupled with the words "transfer from reserve" are a clear representation to the shareholders that the company had earned in that year £439,000 odd, subject to some modest matter of adjustment of some taxation reserves, and that the transfer from reserves amounted to £150,000 in all. The facts were that the balance of £439,000 was only brought about by wholesale transfers from hidden reserves which had nothing whatever to do with that year at all.'

In the course of the trial it was made clear that at the instance of the auditor the words 'balance for the year' had been substituted at a previous period for 'profit for the year' which had formerly appeared. Further, the saving clause 'adjustment of taxation reserves' was also inserted at the suggestion of the auditor. Both these forms of wording were, apparently, intended by him to render the caption of the accounts strictly accurate.

Notwithstanding that the trial resulted in an acquittal, the fact that the Law Officers of the Crown could consent to the making of the charges was regarded as extremely significant. While it could not be said that the creation of secret reserves was contrary to law, it became clear that there were grave objections to using secret reserves so as to alter and reverse the apparent trend of trading results in the mind of the uninstructed reader of a series of accounts. It was immediately

seen that no auditor could safely lend his approval to the use of secret reserves in such a way. The adherents of the older school of thought nevertheless continued to emphasise the distinction between the creation of secret reserves and their manipulation so as to conceal the trend of trading results.

The effect of the case on professional opinion can be seen in the following extracts from comments made by *The Accountant* on 8th and 29th August, 1931:

'The proceedings at the Old Bailey were, however, much more than a nine days' wonder, and the prosecution, though unsuccessful, has very materially altered the map of the accountancy world. Things can never again be as they were. If we judge the situation aright auditors will not be content to run the great risks the existence of which has been disclosed by the very occurrence of this case. The fact that the accusation was possible is not disposed of by the want of success of the prosecution, and no auditor can happily contemplate the possibility that in the future an experiment may be tried in similar though perhaps different circumstances with himself as the victim.

'... It is sufficient to say that for many years it has been the practice of the accountancy profession, with the knowledge and consent of the general public, to countenance the publication of balance sheets which show the situation as less favourable than that existing in fact. This practice has always existed side by side with an acknowledged obligation on the part of the auditor to be satisfied that such an accumulation of undisclosed reserves is made for the general good of the company.

'... hitherto it has not been the view of the accountancy profession that an auditor is under a duty to differentiate between the balances which go to make up the credit at profit and loss account so long as those balances are from the legal point of view properly distributable items. The responsibility for the prudence or imprudence of distributing the items has been regarded as exclusively within the province of directors.

'... The assertions made in Court by counsel and the comments made by the learned judge in his summing up make it clear that public opinion has moved. The public now looks to auditors for a further measure of protection. Shareholders now demand, if not an exact statement of the results of current trading, yet an assurance that the results disclosed by the accounts of the year are not widely different from those accruing from the ordinary trading processes of the year. If that be a true reading of the situation, new possibilities are, of course, opened up, and we do not think the profession will close its eyes to those possibilities; nor do we think that the argument that the *Royal Mail* case was exceptional in that the existence of current losses was not clearly brought out, will be allowed to deflect consideration from the wider and more general demand by the public for candour in statements of account.

'... In our opinion the first objective of reforming energy must be the old-established idea that secrecy is a necessary adjunct of commercial success. In modern conditions trade is by no means so generally the war to be fought behind a smoke screen as the obscurantist party would have us to believe. We are not persuaded that joint-stock finance can either retain or regain its health while smothered in its Victorian garments of secrecy. The commercial community is likely to benefit, we believe, by a cleansing draught of fresh air, notwithstanding that some ailing patients may take cold from its sudden application.

'... it would not, we think be practical politics to make compulsory the disclosure of the setting aside of "secret" reserves. There is no need to explain to accountant readers, who know very well the variety of means which may be adopted for building up such reserves, the reasons with which we could support our statement. On the other hand we think public opinion is moving towards a point where it can legitimately be demanded that if "secret" reserves be utilised for the purpose of reinforcing trading profits of a year, then the facts of that reinforcement should be made clear. The gravamen of the charge in the *Royal Mail* case was that this reinforcement had taken place in a manner which altered the whole apparent trend of trading results. The charge failed, but it must

be taken as evidence that some form of public demand must exist. As we have explained above, accountants have no desire to resist that demand if it does exist and, consequently, if it were possible to devise forms of publication which would make certain the disclosure of non-recurrent items of income, we think that a reform in the direction indicated would receive a distinct welcome on the part of the accountancy profession.'

During the years that followed, the development of opinion was rapid. A higher standard in methods of presentation and in disclosure of information could be observed in the published accounts of an increasing number of companies, and when, in 1943, the Institute of Chartered Accountants began the publication of the remarkable series of Recommendations on Accounting Principles, it was apparent that the weight of responsible opinion was in favour of the maximum practicable disclosure in accounts. By comparison with the views which prevailed less than twenty years earlier, the Recommendations have been justly described as embodying a revolution in accounting thought.

The Recommendations on Accounting Principles are reproduced in full in Appendix C. The following extracts from Recommendations VI and VIII illustrate the new conceptions in regard to disclosure.

From Recommendation No. VI:

'A true appreciation of the financial position of a company as disclosed by its balance sheet may be rendered difficult or even impossible owing to lack of information as to the extent of undisclosed reserves and to insufficient distinction being made between (a) free reserves retained to strengthen the financial position or to meet unknown contingencies; (b) capital reserves or other reserves not normally regarded as available for distribution as dividend; (c) provisions for known contingencies; and (d) provisions for diminution in value of assets in excess of normal or estimated requirements.

'The terms "reserves" and "provisions" are commonly regarded as interchangeable. Accounts would be more clearly understood if the term "reserve" were applied only to reserves which are free, and the term "provision" were confined to amounts set aside for specific requirements.

'Unless the amounts involved are stated, the trend of profits may be obscured by transferring amounts to or from undisclosed accounts of the nature of free reserves, by charging abnormal provisions or by utilising provisions no longer required.

'It is therefore recommended that:

'(1) The following distinction should be made between reserves which are free and those in the nature of provisions for specific requirements; the latter should preferably be described as "provisions":

(a) the term "reserve" should be used to denote amounts set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist as at the date of the balance sheet.

'(2) Reserves, as defined in (1) (a) above, should be disclosed in the balance sheet.

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'(4) . . . where reserves or provisions are created or increased, the amounts involved, if material, and the sources from which they have been created or increased, should be disclosed in the accounts. In all cases, the utilisation of reserves, and of provisions proved to have been redundant, should be disclosed in the accounts.'

From Recommendation No. VIII:

'Businesses are so varied in their nature that there must be flexibility in the manner of presenting accounts and a standard form to suit every commercial and industrial undertaking is neither practicable nor desirable. The financial

position can, however, be more readily appreciated if the various items in the balance sheet are grouped under appropriate headings and a proper view of the trend of the results can be obtained only if certain principles are consistently applied and if profits or losses of an exceptional nature or relating to previous periods are stated separately in the profit and loss account. In both cases, appreciation is facilitated if the comparative figures of the previous period are also given. . . .

'The profit and loss account should be presented in such a form as to give a clear disclosure of the results of the period and the amount available for appropriation, for which purpose it may conveniently be divided into sections.

'Such a disclosure implies substantial uniformity in the accounting principles applied as between successive accounting periods; any change of a material nature such as a variation in the basis of stock valuation or in the method of providing for depreciation or taxation, should be disclosed if its effect distorts the results. The account should disclose any material respects in which it includes extraneous or non-recurrent items or those of an exceptional nature, and should also refer to the omission of any item relative to, or the inclusion of any item not relative to, the results of the period.'

The views expressed by the Institute in the Recommendations on Accounting Principles and in the evidence submitted on its behalf to the Cohen Committee on Company Law Amendment were substantially accepted by the Committee. There are, of course, discrepancies between the terms of the Recommendations on Accounting Principles and the requirements of the Companies Act, 1948, but the main substance of the Recommendations has been embodied in the Act.

The following passages are taken from the report of the Cohen Committee on Company Law Amendment.

From paragraph 5:

'We are satisfied by the evidence that the great majority of limited companies, both public and private, are honestly and conscientiously managed. We believe that the system of limited liability companies has been and is beneficial to the trade and industry of the country and essential to the prosperity of the nation as a whole. The Companies Acts have been amended from time to time to bring them into accord with changing conditions, but if there is to be any flexibility opportunities for abuse will inevitably exist. We consider that the fullest practicable disclosure of information concerning the activities of companies will lessen such opportunities and accord with a wakening social consciousness. Accordingly, while in making our recommendations we have borne in mind the importance of not placing unreasonable fetters upon business which is conducted in an efficient and honest manner, we have included a number of proposals to ensure that as much information as is reasonably required shall be made available both to the shareholders and creditors of the companies concerned and to the general public.'

Paragraph 7 (d):

'The present legal requirements as to the contents of the accounts to be presented to shareholders are too meagre. The practice of showing a number of diverse items in one lump sum and thereby obscuring the real position as to the assets and liabilities, and as to the results of trading, makes it difficult and often impossible for a shareholder to form a true view of the financial position and earnings of the company in which he is interested. While auditors have tended to press for standards in advance of the requirements of the present law, it has been suggested that their hands would be strengthened if the law were to accord more nearly with what they regard as the best practice.'

From paragraph 97:

'The amount of information disclosed in the accounts of companies varies widely. The recent tendency has been to give more information and this tendency has been fortified by the valuable recommendations published from time to time by the responsible accountancy bodies as the form in which accounts should

be drawn up and the information which they should contain. The directors of many, but by no means all, companies now give shareholders as much information as they consider practicable and the accounts which they present contain much more detail than is required by law. Auditors use their influence to persuade directors to present their accounts in accordance with the principles laid down by the professional bodies to which they belong, but in the absence of statutory requirements they cannot over-ride the directors and in some cases may be deterred from pressing their views by fear of losing their position as auditors. The professional bodies representing the accountants who gave evidence before us all agreed that the position of auditors would be strengthened if the law were to prescribe a minimum amount of information to be disclosed in all balance sheets and profit and loss accounts. We accept this view. . .

From paragraph 101:

'The chief matter which has aroused controversy is the question of undisclosed, or, as they are frequently called, secret or inner reserves. An undisclosed reserve is commonly created by using profits to write down more than is necessary such assets as investments, freehold and leasehold property or plant and machinery; by creating excessive provisions for bad debts or other contingencies; by charging capital expenditure to revenue; or by undervaluing stock-in-trade. Normally the object of creating an undisclosed reserve is to enable a company to avoid violent fluctuations in its published profits or its dividends.

'The objections urged against undisclosed reserves can be summarised as follows. As the assets are undervalued or the liabilities overstated, the balance sheet does not present a true picture of the state of the company's affairs; the balance of profit disclosed as available for dividends is diminished, and the market value of the shares may accordingly be lower than it might otherwise be; and the creation, existence or use of reserves, known only to the directors, may place them in an invidious position when buying or selling the shares.

'On the other hand, if there is no detailed disclosure in the profit and loss account, undisclosed reserves accumulated in past periods may be used to swell the profits in years when the company is faring badly, and the shareholders may be misled into thinking that the company is making profits when such is not the case. Such abuses are rare, and, in general, directors have concealed reserves from shareholders in the belief that such concealment is in the interests of the company. None the less the practice has the unfortunate result that shareholders and investors and their advisers have not the information to enable them to estimate the real value of the shares.

'We do not believe that, if fully informed, shareholders would press for excessive dividends and we are in favour of as much disclosure as practicable. It is also important in our opinion to ensure that there should be adequate disclosure and publication of the results of companies so as to create confidence in the financial management of industry and to dissipate any suggestion that hidden profits are being accumulated by industrial concerns to the detriment of consumers and those who work for industry. We have framed recommendations with which we think most companies should comply.'

THE REQUIREMENTS OF THE COMPANIES ACT, 1948.

(Note: The provisions of the Act affecting holding and subsidiary companies are dealt with in Chapter IX).

Section 149 (1) provides that:

'Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of its financial year, and every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year.'

Section 149 (2) provides that:

'A company's balance sheet and profit and loss account shall comply with the requirements of the Eighth Schedule to this Act, so far as applicable thereto.'

The guiding principle of 'a true and fair view' is thus laid down in Section 149 (1), and requirements as to the principles to be followed in the presentation of accounts and as to the disclosure of information on a number of specified matters are contained in the Eighth Schedule. The Eighth Schedule also provides that certain special classes of companies shall be exempted from some of the requirements. There are also, as will be shown in this chapter, certain other sections in the Act which affect the profit and loss account and balance sheet.

It is interesting to contrast the phrase 'true and fair view' with the phrase 'true and correct view' which occurred in Section 134 of the Companies Act, 1929, in relation to the auditor's report. In this respect, the Companies Act, 1948, appears to be less stringent than the Act of 1929. It is suggested that the word 'correct' is too rigid, conveying as it does the implication that one set of figures alone is correct, and that any conceivable alternative is therefore incorrect. It is hardly necessary to remind the reader that the element of estimate must enter very largely into many figures in both profit and loss account and balance sheet, and that in many cases estimates somewhat different from those actually adopted may be equally legitimate. The employment of the word 'fair' overcomes this objection, and opens the door to a reasonable flexibility.

The Act does not allow any relaxation, in any circumstances, of the requirements of Section 149 (1) as to a 'true and fair view'. It is made clear, in Section 149 (3), that compliance with the requirements of the Eighth Schedule is not to be regarded as a substitute for presenting a true and fair view in the accounts and balance sheet. The obligation to present a true and fair view is paramount.

The complexity of the requirements of the Act is such that it was foreseen that their practical application would give rise to many difficulties. To avoid the necessity of amending the Act at an early date, the Board of Trade has been given very wide powers of relaxing and amending the requirements of the Act in regard to accounts and balance sheets. Section 149 (4) gives the Board a power of dispensation in individual cases, in the following terms:

'The Board of Trade may, on the application or with the consent of a company's directors, modify in relation to that company any of the requirements of this Act as to the matters to be stated in a company's balance sheet or profit and loss account (except the requirements of subsection (1) of this section) for the purpose of adapting them to the circumstances of the company.'

Section 454 (1) gives the Board the power of making amendments of general application:

'The Board of Trade shall have power by regulations made by statutory instrument to alter or add to the requirements of this Act as to the matters to be stated in a company's balance sheet, profit and loss account and group accounts, and in particular of those of the Eighth Schedule to this Act. . .'

It is provided that any regulations having the effect of rendering the requirements more onerous must be approved by both Houses of Parliament, and that any regulations not having such an effect may be annulled by resolution of either House of Parliament.

It may be observed that there is no power to alter the requirement of Section 149 (1) as to a true and fair view.

The Board is also given particular powers of dispensation in regard to the provisions relating to holding and subsidiary companies and in regard to certain matters dealt with in the Eighth Schedule.

Although, at the time of writing, the Act has been in force for little more than a year, the need for amendment in certain respects has already become clear, and the Council of the Institute of Chartered Accountants has already (in July, 1949) submitted an interim memorandum to the Board of Trade embodying a number of suggestions as to revision of the Act. The application of the Act to company accounts has, however, created fewer difficulties than might have been feared, and the Board of Trade has shown a readiness to use its powers of relaxation in cases of need.

(a.)
(b.)

I. THE BALANCE SHEET

The requirements of the Act in regard to the balance sheet must now be considered in detail. The reader will bear in mind that compliance with the provisions of the Eighth Schedule does not relieve those responsible of the duty to observe the overriding principle that the balance sheet shall give a true and fair view of the state of affairs.

SHARE CAPITAL. The authorised and issued share capital must be summarised. (Eighth Schedule, paragraph 2.)

It is necessary to specify:

- '(a) any part of the issued share capital that consists of redeemable preference shares, and the earliest date on which the company has power to redeem those shares;
- (b) so far as the information is not given in the profit and loss account, any share capital on which interest has been paid out of capital during the financial year, and the rate at which interest has been so paid.' (Eighth Schedule, paragraph 2.)

The conditions under which redeemable preference shares may be issued and redeemed have been explained in Chapter IV. It may here be noted that by Section 58 (3) the redemption of such shares does not operate to reduce the amount of the company's authorised share capital.

It has been held by the Court that, under the 1929 Act, the redemption of preference shares operated to reduce the authorised share capital of the company, even though the company is entitled to reissue the redeemed shares. Counsel have expressed the opinion (I.C.A., paragraph 138) that Section 58 (3) applies only to redemptions effected on or after 1st July, 1948.

Section 65 permits, subject to certain conditions, the payment of interest on share capital where shares have been issued for the purpose of providing money 'to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period.'

It is necessary to show:

'the number, description and amount of any shares in the company which any person has an option to subscribe for, together with the following particulars of the option, that is to say

- (a) the period during which it is exercisable;
 - (b) the price to be paid for shares subscribed for under it.'
- (Eighth Schedule, paragraph 11 (2).)

There must also be disclosed:

'the amount of any arrears of fixed cumulative dividends on the company's shares and the period for which the dividends or, if there is more than one class, each class of them are in arrear, the amount to be stated before deduction of income-tax, except that, in the case of tax-free dividends, the amount shall be shown free of tax, and the fact that it is so shown shall also be stated.'

(Eighth Schedule, paragraph 11 (3).)

The information required by paragraph 11 is to be stated by way of a note, or in a statement or report annexed to the balance sheet, if not otherwise shown.

RESERVES AND PROVISIONS. (a) **DEFINITIONS:** In the words of the Recommendations on Accounting Principles, 'the terms "reserves" and "provisions" are commonly regarded as interchangeable'. The term 'reserve' was, in the past, frequently used to represent not only accumulated profits or surpluses, but also liabilities and reductions in the value of assets. It is not surprising that this lack of clear definition frequently led to confusion and ambiguity, and facilitated the concealment of the true position. The position of a company could be understated by giving free reserves the appearance of liabilities and the trend of trading results could be distorted by bringing back concealed reserves to the credit of profit and loss account in a later period.

In order to prevent concealment and distortion, the Institute recommended that:

- '(a) the term "reserve" should be used to denote amounts set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist as at the date of the balance sheet.
- '(b) The term "provision" should be used to denote amounts set aside out of profits or other surpluses to meet:
 - (i) specific requirements the amounts whereof can be estimated closely; and;
 - (ii) specific commitments, known contingencies and diminutions in value of assets existing as at the date of the balance sheet where the amounts involved cannot be determined with substantial accuracy.'

While the main substance of the Recommendations of the Institute in regard to the form and content of the balance sheet and profit and loss account has been embodied in the Companies Act, the Act and the Recommendations are not completely identical in their effect. One of the important points of divergence lies in the definition of reserves and provisions in the Act.

Reserves and provisions are defined in paragraph 27 (1) of the Eighth Schedule, as follows:

'For the purpose of this schedule, unless the context otherwise requires,

- (a) the expression "provision" shall subject to sub-paragraph (2) of this paragraph, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way

of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(b) the expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;

(c) the expression "capital reserve" shall not include any amount regarded as free for distribution through the profit and loss account and the expression "revenue reserve" shall mean any reserve other than a capital reserve;

and in this paragraph the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.'

The significance of the proviso regarding sub-paragraph (2) will be considered below.

The above definitions differ from those given in the Recommendations on Accounting Principles in some important respects. In the first place, the definition in the Eighth Schedule of 'provision' is such that the expression cannot be used in regard to liabilities the amounts whereof can be estimated closely. Secondly, the expression 'liability' which occurs in the definition of 'provision' in the Eighth Schedule has a more restricted meaning than the 'requirements', 'commitments', and 'contingencies' of the definition in the Recommendations. In consequence, the Council of the Institute found it necessary to amend their original recommendation in regard to provisions, and new recommendations issued by the Institute included the following:

'The word "provision" should cease to be used to denote amounts set aside to meet specific requirements the amounts whereof can be estimated closely; such amounts should be grouped with creditors since they represent liabilities or accruals.'

If the balance sheet is to serve its purpose of presenting a true and fair view, it is clearly essential to distinguish between liabilities the amount of which is precisely known or can be estimated closely and those the amount of which cannot be determined with substantial accuracy.

Although in the original recommendation of the Institute, the expression 'provision' was applied to amounts representing liabilities of both kinds, the need for distinguishing between them was recognised in paragraph 48 of the recommendation, in the following sentence:

'As a general principle, "provisions" as defined under (1) (b) (ii) should be disclosed in the balance sheet under one or more appropriate headings.'

The Companies Act requires the separate disclosure of provisions representing liabilities the amount of which cannot be determined with substantial accuracy, and at the same time prohibits the use of the word 'provision' in connection with liabilities, the amount of which is precisely known or can be estimated closely. It is a matter for regret that the meaning of 'provision' has been restricted in this way, and it is difficult to see what useful purpose is served by the restriction. The separate disclosure of provisions representing liabilities not capable of being estimated closely could have been required without so restricting the meaning of the word.

The word 'reserve' is defined in paragraph 27 of the Eighth Schedule in a negative way. We are told what a reserve is not, but we are not

told in positive terms what it is. The expression 'capital reserve' is also described in a negative way, and a 'revenue reserve' is defined as 'any reserve other than a capital reserve'.

Despite the lack of a comprehensive definition, the terms of the Act appear to be designed to reflect the intentions of the Recommendations of the Institute in regard to these expressions.

There is considerable difference of opinion as to the interpretation of the definition of 'capital reserve', and this had led to a lack of uniformity in the classification of reserves. It is quite clear that a reserve which cannot legally be distributed as a dividend is a capital reserve, but there is no general agreement as to the treatment of reserves which, though legally available for dividend, the directors do not intend to use for that purpose. The view of those who hold that the expression 'capital reserve' should be confined to reserves which are not legally available for distribution appears to be an unduly narrow one. If there had been any intention of limiting the meaning of the expression in this sense, it is reasonable to suppose that a less ambiguous definition would have been adopted. The statement in paragraph 27 that 'the expression "capital reserve" shall not include any amount regarded as free for distribution' appears to make the classification of reserves (if they are legally available for distribution) dependent upon the intention of the directors. If this is the right interpretation of the definition, no rigid rules for the division of reserves into capital reserves and revenue reserves can be laid down. Indeed, a reserve which is classified as a capital reserve at one date might subsequently be treated as a revenue reserve if the circumstances of the company have altered and the policy and intentions of the directors have changed.

We may note at this point sub-paragraph (2) of paragraph 27 of the Eighth Schedule, which provides as follows:

'Where (a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or (b) any amount retained by way of providing for any known liability; is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this schedule as a reserve and not as a provision.'

It is therefore not permissible to conceal the true position of a company by making exaggerated provisions for liabilities or for the depreciation of fixed assets. The terms of this sub-paragraph, so far as they relate to depreciation, renewals or diminution in value of assets, have not been easy to interpret. These difficulties are more suitably considered below under the heading 'Fixed Assets'.

(b) DISCLOSURE OF RESERVES AND PROVISIONS IN THE BALANCE SHEET: By paragraph 4 (1) of the Eighth Schedule, it is required that:

'The reserves, provisions, liabilities and fixed and current assets shall be classified under headings appropriate to the company's business.'

More precise requirements are contained in paragraph 6, which is as follows:

'The aggregate amounts respectively of capital reserves, revenue reserves and provisions (other than provisions for depreciations, renewals or diminution in value of assets) shall be stated under separate headings:

Provided that—

- (a) this paragraph shall not require a separate statement of any of the said three amounts which is not material; and
- (b) the Board of Trade may direct that it shall not require a separate statement of the amount of provisions where they are satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived at after taking into account a provision (other than as aforesaid) shall be so framed or marked as to indicate that fact.'

By proviso (a) there is no necessity to disclose trifling amounts. The dispensing power of the Board of Trade under proviso (b) is additional to its powers under Section 149 (4) and Section 454 (1) to which reference has been made above.

It will be observed that paragraph 6 does not require the separate disclosure of provisions for depreciation, renewals or diminution in value of assets. Subject to certain qualifications, the disclosure of provisions for depreciation and renewal of fixed assets is, however, necessary under paragraph 5; this requirement can more conveniently be considered below under 'Fixed Assets'. There is no necessity to disclose any provision for the diminution in the value of a current asset, e.g. provision for bad debts, unless indeed such a provision is so significant that disclosure becomes necessary under the obligation to present 'a true and fair view' of the state of affairs.

Paragraph 6 requires the separate statement of three distinct amounts, (1) capital reserves, (2) revenue reserves, and (3) provisions in respect of liabilities. In addition, any share premium account must, by paragraph 2 (c) of the Eighth Schedule, be separately stated on the balance sheet. By Section 72 of the Act, the provisions of the Act relating to the reduction of capital apply to the share premium account. The opinion of counsel (I.C.A., paragraph 140) is that the share premium account should appear in the balance sheet as a separate item under the heading of capital reserves. Paragraph 5 (4) of the Eighth Schedule requires the separate disclosure of any provision for renewals of fixed assets, in so far as such a provision has not been used by charging the cost of replacement against it. This matter will be considered in greater detail below under 'Fixed Assets'.

Paragraph 6 requires the disclosure of the *aggregate* only of each of the three amounts, capital reserves, revenue reserves and provisions in respect of liabilities. It is considered, however, that this is a minimum requirement, and that there is no barrier to disclosure in greater detail. As regards provisions in respect of liabilities, there is, indeed, a danger that the disclosure of the aggregate only might fall short of a true and fair view, since some of these provisions might represent current liabilities while others might represent liabilities which are not due for payment until a more distant date.

The Recommendation of the Council of the Institute of Chartered Accountants on this matter is as follows:

'On a proper grouping of the balance sheet some provisions will not be suitable for aggregation; for example, where some provisions are current liabilities and

others are not. In such cases, an aggregate should be regarded as a minimum requirement intended to avoid the unnecessary disclosure of separate items which individually have no significance; it should not be treated as a restriction operating against the presentation of a true and fair view.' (I.C.A., paragraph 106).

(c) **MOVEMENTS IN RESERVES AND PROVISIONS.** The source of increases in reserves and liability provisions must be disclosed. If there is a decrease in reserves or a decrease in liability provisions, after making allowance for the application of such provisions for their proper purpose, the application of the amount of the decrease must also be disclosed. If, however, the information is given in the profit and loss account, it is not necessary to repeat it in the balance sheet.

The requirements of the Eighth Schedule as to the disclosure in the balance sheet of movements in reserves and provisions are contained in paragraph 7:

'(1) There shall also be shown (unless it is shown in the profit and loss account or a statement or report annexed thereto, or the amount involved is not material)—

(a) Where the amount of the capital reserves, of the revenue reserves or of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) shows an increase as compared with the amount at the end of the immediately preceding financial year, the source from which the amount of the increase has been derived, and

(b) Where—

(i) the amount of the capital reserves or of the revenue reserves shows a decrease as compared with the amount at the end of the immediately preceding financial year; or

(ii) the amount at the end of the immediately preceding financial year of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) exceeded the aggregate of the sums since applied and amounts still retained for the purposes thereof;

the application of the amounts derived from the difference.

'(2) Where the heading showing any of the reserves or provisions aforesaid is divided into sub-headings, this paragraph shall apply to each of the separate amounts shown in the sub-headings instead of applying to the aggregate amount thereof.'

It is clear that movements in (a) capital reserves, (b) revenue reserves and (c) liability provisions must be shown separately and distinguished.

It is to be noted that the paragraph does not apply if the amount involved is not material.

If the balance sheet discloses the aggregate only of any of the three classes, without details or subdivisions, it is sufficient, as far as paragraph 7 is concerned, to show the source or application of the increase or decrease in the aggregate. It is obviously desirable, however, to show the movements in greater detail, since failure to do so might in many cases constitute a breach of the overriding requirement to show a true and fair view.

Paragraph 7, it will be noted, provides that, if the required information is given in the profit and loss account or a statement or report annexed thereto, it is not also necessary to give it in the balance sheet. In regard to the profit and loss account, paragraph 12 of the Eighth Schedule requires the disclosure, *inter alia*, of:

'(e) the amount, if material, set aside or proposed to be set aside to, or withdrawn from, reserves;

'(f) subject to sub-paragraph (2) of this paragraph, the amount, if material, set aside to provisions other than provisions for depreciation, renewals or diminution in value of assets or, as the case may be, the amount, if material, withdrawn from such provisions and not applied for the purposes thereof.'

Sub-paragraph (2) gives the Board of Trade power to dispense with the requirement to show the amount set aside to provisions, if the Board is satisfied that that is not required in the public interest, and would prejudice the company.

Apart from the powers given to the Board of Trade, the terms of paragraph 12 appear to apply to all reserves and liability provisions without exception. If this is so, the requirements of paragraph 7 as to disclosure in the balance sheet would seem to be superfluous. Moreover, a strict interpretation of paragraph 12 would involve the incorporation in the profit and loss account of additions to or withdrawals from capital reserves. The opinion of counsel (I.C.A., paragraph 102) is that this curious result was not intended by the framers of the Act. It is pointed out that a sum transferred to a capital reserve in respect of a capital receipt could not be shown in the profit and loss account without also showing the receipt on the other side of the account.

The Council of the Institute has made the following recommendation (I.C.A., paragraph 104):

'In view of the opinion expressed by counsel the Council considers that, pending clarification which is being sought from the Board of Trade, regard may fairly be had to what appears to have been the intention of Parliament and therefore recommends that normally all additions or withdrawals affecting the profit and loss account should be passed through that account but those involving capital transactions need not appear in that account.'

In the memorandum of 6th July, 1949, submitted to the Board of Trade by the Council of the Institute it is suggested that the Eighth Schedule should be amended in this respect.

(d) **THE PRACTICAL APPLICATION OF THE DEFINITIONS.** No difficulty arises in the treatment of profits and surpluses which are not legally available for distribution; they are capital reserves. This group will include share premium account, a capital redemption reserve fund set up in connection with the redemption of redeemable preference shares, profits prior to incorporation, and post-war refunds of excess profits tax. The treatment of reserves which are legally available for distribution will depend, to a great extent, on the view taken by the directors. In classifying such reserves as either capital or revenue, the directors should take into account the origin of each reserve and the purpose for which it is retained. On this test, a surplus on the sale of a fixed asset and a reserve for the enhanced cost of replacing a fixed asset might reasonably be treated as capital reserves. The Council of the Institute has made the following recommendation in regard to reserves to finance replacements (whether of fixed or current assets) at enhanced costs:

'In order to emphasise that as a matter of prudence the amount set aside is, for the time being, regarded by the directors as not available for distribution, it should normally be treated as a specific capital reserve for increased cost of replacement of assets.'

The unappropriated balance on profit and loss account must be treated as a revenue reserve. The recommendation of the Council is as follows (I.C.A., paragraph 109):

'The unappropriated balance on profit and loss account should be treated as a revenue reserve in accordance with the recommendation already made, that the revenue reserves group should "include any undistributed balance, or, by deduction, any adverse balance on profit and loss account".'

A general reserve is usually treated as a revenue reserve. No fixed rules can be made for all reserves, and it must be expected that there will be some diversity of practice.

Difficulties have arisen from the definition of 'provision'. It has been pointed out above that the meaning of 'provision', as defined in paragraph 27 of the Eighth Schedule, is more restricted than the meaning given to the word in the earlier Recommendation of the Institute. Apart from provisions for depreciation, renewals or diminution in value of assets, a provision can only mean an amount retained by way of providing for a known liability of which the amount cannot be determined with substantial accuracy. The question of whether a particular amount is or is not a provision may therefore depend upon the meaning attached to the word 'liability'.

FUTURE INCOME-TAX

The restriction of the meaning of 'provision' has created a situation of peculiar difficulty in the case of the charge to profit and loss account for future income-tax, i.e. income-tax on the profits of the current period, normally assessable for the following fiscal year.

The practice of charging profit and loss account with income-tax on the profits of the current period has, in recent years, become general. It is recommended in one of the earlier Recommendations on Accounting Principles, dated March, 1943, from which the following extracts are taken:

'(2) (a) The charge for income-tax should be based on the profits earned during the period covered by the accounts.

(b) Where it has been the practice to charge only the minimum or legal liability, then, until full provision has been made for income-tax on all profits up to the date of the balance sheet, it is desirable where possible to make provision, in addition, for or towards the balance of the liability for the current and following fiscal years. This provision should be shown separately in the profit and loss account.

'(5) Any provision for (or in excess of) the estimated future liability to income-tax in respect of the fiscal year commencing after the date of the balance sheet should not be included with current liabilities but should be grouped with reserves or separately stated as a deferred liability and suitably described.'

It will be noted that the estimated future income-tax is described in the recommendation as a provision. Although the recommendation suggests that the amount may be grouped in the balance sheet with reserves, it is not suggested that it should be described as a reserve; moreover, the recommendation offers the alternative suggestion that it should be stated in the balance sheet as a deferred liability.

It thus became a common practice to describe the amount of future income-tax in the balance sheet as a provision or deferred liability. To the regret of many, it now appears that such descriptions are

incompatible with the law. The opinion of counsel (I.C.A., paragraph 99) is that an amount set aside to meet future income-tax is not a liability and accordingly cannot be a provision. In addition, in their opinion, 'it follows that for the purposes of this schedule it is necessarily a reserve'.

The opinion that future income-tax is not a liability is reinforced by a recent legal decision (*Re Duffy, in re Lakeman v. Attorney-General* ([1948] 2 All E.R. 756). This case was concerned with the valuation of a company's shares for estate duty purposes, but, taken in conjunction with counsel's opinion quoted above, it is significant. In paragraph 27 of the Eighth Schedule, it is stated that the expression 'liability' shall include all disputed and contingent liabilities, and it has been suggested that this is broad enough to include future income-tax. This, however, was evidently not the opinion of counsel.

In view of the opinion of counsel, the Council of the Institute has amended its recommendations, in the following terms:

- '(a) The word "provision" ceases to be applicable to amounts set aside to meet future income-tax;
- '(b) such amounts should in all cases be grouped with reserves; the alternative of stating them separately as deferred liabilities ceases to be available.'

The amended recommendation has not been universally followed, and a very marked divergence of opinion has become apparent. Those who are reluctant to treat future income-tax, based on the profits of the current period, as a reserve, argue that to do so is a frustration of the purpose of the present practice of charging this amount to profit and loss account. This practice had its origin in the belief that the tax that will ultimately be assessed by reference to the profits of a period is a proper deduction from those profits, despite the fact that the assessment is not made until the following fiscal year. Unless there is any reason to suppose that the business will be discontinued at an early date or that a net loss (leading to a claim for relief from income-tax) will be suffered in the following accounting period, there is a strong probability that a future tax liability will be incurred as a direct consequence of earning the current profits. This view has special force in relation to an accounting period in which profits are exceptionally high, since accounts which show unusually large profits are misleading if no allowance is made for the correspondingly heavy assessment to tax which will normally follow, albeit after an interval of time. It is also pointed out that a purchaser of the company's shares would, in such circumstances, regard at least part of the future income-tax as an item to be deducted from the net assets of the company, as disclosed in the balance sheet. The same idea is also put in the proposition that the position of two companies with identical assets and legal liabilities is not in reality identical if the estimated future income-tax liability of one company is greater than that of the other. In the words of the Institute's Recommendation of March, 1943, 'unless provision be made year by year for income-tax based on each years' results, the trend of net available profits will not be apparent, and cases will arise where the profits earned in a succeeding period will bear a disproportionate charge for taxation—indeed they may even be insufficient to meet it'.

It is not surprising that there is a reluctance to treat future income-tax on current profits as a reserve. If reserves are balances representing profits or surpluses and therefore part of the shareholders' interest or equity, it seems anomalous to include with reserves an amount which is now generally regarded as a proper deduction from profits. The debit to profit and loss account for the future tax liability operates to reduce the amount shown as net available profit; its classification in the balance sheet as a reserve has the appearance of restoring it to the category of profits or surpluses, and the whole transaction is therefore, in a sense, self-cancelling.

The argument that the treatment of future income-tax as a reserve may be justified on the ground that reserves are available to meet contingencies is, in the present writer's opinion, unsatisfactory and even potentially dangerous. Some reserves are, in any event, represented by fixed assets, and are not available in any practical sense. The most serious objection to the inclusion of such an item as future income-tax among reserves is that this method of treatment may tend to break down and confuse the distinction between profits and surpluses, on the one hand, and liabilities, on the other. This distinction is fundamental and necessary to a proper appreciation of the state of affairs, and it is unfortunate that it should be weakened in any way.

The arguments of those who consider that future income-tax is properly classified as a reserve are, first, that no part of this tax has, at the date of the balance sheet, legally accrued, and, secondly, that there is no certainty, at the date of the balance sheet, that it will ever become payable at all. The first of these arguments is not in dispute, but the second is not very convincing, since lack of complete certainty is not held to justify the exclusion of many other items from the accounts. The essence of the difficulty is that, at the date of the balance sheet, the future income-tax is not a legal liability.

In the light of the opinion expressed by counsel, it is difficult to see how the Council of the Institute could have avoided the amendment of their original recommendation.

Despite the expressed opinion of counsel and despite the amended recommendation of the Institute, some companies have sought a way out of the difficulty by showing future income-tax on the left-hand side of the balance sheet as a separate item which is not described as either reserve, provision, or liability. This solution might well become a general practice, but it is not consistent with Counsels' opinion, which does not appear to admit any neutral ground between reserves, on the one hand, and liabilities on the other.

There are many who think that the matter is one which can be settled satisfactorily only by an amendment of the Eighth Schedule in such a way as to permit the separate statement and description in the balance sheet of any items which cannot appropriately be classified under any of the headings which are mentioned in the Schedule. The memorandum submitted by the Council of the Institute in July, 1949, includes a suggestion for the amendment of the Eighth Schedule in this sense. It must be recognised, however, that the law of income-tax which requires the assessment for a fiscal year to be based normally

upon the profits of a previous accounting period is itself anomalous, and while this persists, any conceivable accounting treatment must be open to objections.

It is to be noted that an amount set aside for future income-tax will normally become, in the course of time, a current liability. If the company's financial year ends between 6th April and 31st December, an amount described as a reserve in one balance sheet may appear as a *current liability in the balance sheet at the end of the following year.*

It is a curious fact that while the treatment of future income-tax has been the subject of acute controversy, the practice of including the net amount of proposed dividends among current liabilities has excited little comment. Yet a proposed dividend is not a legal liability at the date of the balance sheet. The present practice commands general assent, and accords with the aim of presenting a true and fair view. None the less, it would seem that, if the most suitable methods of presentation are to be in complete accordance with the law, more than one amendment is required.

DEFERRED REPAIRS

The treatment of future income-tax is not the only problem that has arisen from the restricted meaning of the word 'provision' and the legal interpretation of the word 'liability'. Many companies have set aside substantial amounts to cover the expected cost of repairs that have been deferred in consequence of wartime and post-war difficulties. These amounts were classified as provisions, and it became necessary to consider whether this was correct in the light of paragraph 27 of the Eighth Schedule. The Council of the Institute has made the following recommendations:

'Amounts set aside to meet deferred repairs the execution of which is a contractual or statutory obligation (e.g. under a dilapidations clause of a lease) should be treated as liabilities if the amounts can be determined with substantial accuracy and as provisions if the amounts cannot be so determined.

'Other amounts set aside to meet deferred repairs because they are regarded as charges necessary for the correct computation of profits should be treated as provisions, on the footing that they are closely analogous to amounts provided for renewals (which are specifically required to be treated as provisions) and differ from these in degree rather than in character.'

It will be seen that, in the case of amounts set aside to meet deferred repairs in the absence of any contractual or statutory obligation, the alternative meaning of 'provision' offered a way of escape from a dilemma that would otherwise have resembled the case of future income-tax. Similar treatment would appear appropriate in the case of a credit balance on an equalisation account for repairs to plant and machinery.

It would be unwise to overlook the possibility that other problems may arise for which a solution may not so readily be found. If it is thought proper to charge profit and loss account with an amount which is not related to depreciation renewals or diminution in value of assets and which is not accompanied by the existence of a legal liability at the date of the balance sheet, the difficulties which have appeared in connection with future income-tax will be repeated.

The essence of the difficulty is expressed in the following passage from the judgment delivered by Lord Greene in the case cited above, *Re Duffy (deceased), Lakeman v. Attorney-General* ([1948] 2 All E.R. 756).

Referring to the phrase 'liabilities of the company', which occurs in Section 50 of the Finance Act, 1940, Lord Greene said:

'Taking the construction of these words, I find it impossible to give them a meaning extending beyond what is always ascertainable without any doubt whatsoever, namely, an existing legal liability—a liability actually existing in law at the relevant date. The words cannot be stretched so as to cover something which in a business sense is morally certain and for which every business man ought to make provision, but which in law does not become a liability until a subsequent date.'

LIABILITIES

Paragraph 4 (1) of the Eighth Schedule provides that 'the reserves, liabilities, and fixed and current assets shall be classified under headings appropriate to the company's business'.

The meaning of 'liability' has been considered above.

Paragraph 4 also provides that where the amount of any class is not material, it may be included under the same heading as some other class.

The Act does not prescribe any list of separate categories in which liabilities must be shown. The reference in paragraph 4 to 'headings appropriate to the company's business' and the overriding requirement that the balance sheet should give a true and fair view must be borne in mind. It is obviously desirable that current liabilities should be distinguished from long-term liabilities; if this distinction is not made the balance sheet could scarcely be said to give a true and fair view. There is no legal or statutory definition of 'long-term' or 'current', but in the Recommendations on Accounting Principles, it is suggested that 'the expression "long-term" is intended to cover liabilities not due for payment until after the lapse of one year from the date of the balance sheet'. If this definition is accepted, current liabilities are those due for payment not later than one year after the date of the balance sheet.

In addition to the general requirement of paragraph 4 regarding liabilities, the Eighth Schedule requires the disclosure of certain matters which may conveniently be considered under this heading.

(1) The aggregate amount of bank loans and overdrafts must be shown under a separate heading. (Paragraph 8 (1) (d).)

(2) The net aggregate amount (after deduction of income-tax) which is recommended for distribution by way of dividend must also be shown under a separate heading. (Paragraph 8 (1) (e).)

(3) Where any liability of the company is secured otherwise than by operation of law on any assets of the company, the fact that the liability is so secured shall be stated, but it shall not be necessary to specify the assets on which the liability is secured. (Paragraph 9.)

(4) Particulars of any redeemed debentures which the company has power to reissue must be specified. (Paragraph 2 (d).)

(5) The following matters must be stated by way of note or in a statement or report annexed to the balance sheet, if not otherwise shown:

- (a) Particulars of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secured. (Paragraph 11 (4).)
- (b) The general nature of any contingent liabilities not provided for and, where practicable, the aggregate amount or estimated amount of those liabilities, if it is material. (Paragraph 11 (5).)
- (c) Where practicable the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for.
- (d) The basis on which foreign currencies have been converted into sterling, where the amount of the assets or liabilities affected is material.
- (e) The basis on which the amount, if any, set aside for United Kingdom income-tax is computed.

The obligation to give information relating to matters which are not, and in some cases, cannot conveniently be reflected by means of balances in the ledger is of particular significance. There is a recognition of the fact that a balance sheet, considered simply as a statement of ledger balances, cannot always provide a full and complete picture of the position of a company.

The Act does not specifically require the separate disclosure of liabilities for current taxation, neither is there any specific requirement as to the disclosure of interest accrued on debentures and long-term liabilities. The separate disclosure of these amounts is, however, recommended in the Recommendations on Accounting Principles.

ASSETS

(a) **CLASSIFICATION OF ASSETS.** The general requirements of paragraph 4 of the Eighth Schedule have been mentioned above, in connection with reserves and provisions and liabilities.

The full text of paragraph 4 is as follows:

'(1) The reserves, provisions, liabilities and fixed and current assets shall be classified under headings appropriate to the company's business:

Provided that—

- (a) where the amount of any class is not material, it may be included under the same heading as some other class; and
- (b) where any assets of one class are not separable from assets of another class, those assets may be included under the same heading.

'(2) Fixed assets shall also be distinguished from current assets.

'(3) The method or methods used to arrive at the amount of the fixed assets under each heading shall be stated.'

It will be observed that, as in other passages in the Eighth Schedule, the separate disclosure of trivial amounts is not required.

There is no list of separable categories for the classification of assets. Any rigid system of classification would lead to many difficulties in practice, since the circumstances of business undertakings are so varied. The headings mentioned in the Recommendations on Accounting Principles as suitable for separate classification are a useful guide.

The Recommendations include the useful suggestion that debts of material amount not due until after the lapse of one year from

the date of the balance sheet should be separately grouped and suitably described.

In the report of the Cohen Committee on Company Law Amendment, it was recommended that the proposed Act should define fixed assets as 'assets not held for sale or for conversion into cash', and current assets as 'cash and assets held for conversion into cash'. These definitions were not, however, incorporated in the Act.

It is not always possible or reasonable to classify every asset as either fixed or current. Some assets may be partly fixed and partly current in character, and certain items which are shown on the right-hand side of the balance sheet may be more suitably shown as separate items apart from the two main categories. Items which are difficult to classify include short workings under royalty agreements, interests in subsidiary companies, preliminary expenses and expenses in connection with the issue of shares or debentures. The opinion of counsel (I.C.A., paragraphs 55-56) appears to be that the terms of the Eighth Schedule require the classification of all assets as either fixed or current; they suggest that the only way of dealing with cases where neither 'fixed' nor 'current' would be a suitable description is to apply to the Board of Trade to exercise their power to alter the provisions of the Eighth Schedule. The Council of the Institute has been in communication with the Board of Trade, 'and is authorised to state that no objection will be taken to an asset not being described as "fixed" or "current" if to do so would not be a true and fair description, provided the nature of the asset is stated clearly'.

Apart from items which, for the above reasons, will not normally be classified as either fixed or current, every asset must be clearly described as either fixed or current. This may be done either by describing each asset specifically, or by grouping the assets under two main headings of 'Fixed Assets' and 'Current Assets'. The latter alternative is normally adopted. A mere description of the asset, without a clear indication of its classification as fixed or current, is not sufficient. (See I.C.A., paragraph 54.)

(b) **ITEMS TO BE STATED UNDER SEPARATE HEADINGS.**
The following so far as they are not written off must be separately stated in the balance sheet.

The paragraph numbers refer to the Eighth Schedule.

- (1) Preliminary expenses. (Paragraph 3 (a)).
- (2) Any expenses incurred in connection with any issue of share capital or debentures. (Paragraph 3 (b)).
- (3) Any sums paid by way of commission in respect of any shares or debentures. (Paragraph 3 (c)).
- (4) Any sums allowed by way of discount in respect of any debentures. (Paragraph 3 (d)).
- (5) The amount of the discount allowed on any issue of shares at a discount. (Paragraph 3 (e)).
- (6) Goodwill, patents and trade-marks. It is not necessary to distinguish individually between the three items included in this

heading. The separate statement of goodwill, patents and trade-marks is required only if the amount is shown as a separate item or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property.

If part of the amount is shown as a separate item in the books or is otherwise ascertainable, that part must be separately stated in the balance sheet. (Paragraph 8 (1) (b) and Paragraph 8 (2).)

The qualification 'so far as not written off' is important. It implies that it is not necessary to disclose the cost and aggregate amount written off in respect of any of the above items. This is in contrast to the general principle by which the cost (or valuation) and aggregate depreciation of fixed assets must be disclosed.

Investments. The following items must also be separately stated in the balance sheet, and in these cases the qualification 'so far as not written off' does not apply.

- (1) Trade investments.
- (2) Quoted investments other than trade investments in respect of which there has been granted a quotation or permission to deal on a recognised stock exchange.
- (3) Quoted investments other than trade investments in respect of which there has not been granted a quotation or permission to deal on a recognised stock exchange.
- (4) Unquoted investments.

The requirements regarding the disclosure of investments are contained in paragraph 8 (1) (a) and paragraph 8 (3) of the Eighth Schedule.

'Trade investments' are not defined, but the expression is usually applied to investments held with a view to promoting the business interests of the company.

By paragraph 28 of the Eighth Schedule, the expression 'quoted investment' is defined as an investment as respects which there has been granted a quotation or permission to deal on a recognised stock exchange or on any stock exchange of repute outside Great Britain. In Section 455 of the Act, 'recognised Stock Exchange' is defined as any body of persons which is for the time being a recognised stock exchange for the purposes of the Prevention of Fraud (Investments) Act, 1939. Under the latter Act, a recognised stock exchange can only be a body of persons carrying on business in Great Britain. It therefore follows that investments falling under (3) above, i.e. 'quoted investments other than trade investments in respect of which there has not been granted a quotation or permission to deal on a recognised stock exchange' are those in respect of which there has been granted a quotation or permission to deal on a stock exchange of repute outside Great Britain.

The requirements of the Eighth Schedule in regard to the valuation of investments are considered later in this chapter.

Loans for the purchase of the company's shares. Section 54 of the Act prohibits the provision of financial assistance, whether directly or indirectly, by a company for the purchase of or subscription for its own shares. In the case of a subsidiary company, the prohibition also applies to the purchase of or subscription for its holding company's shares. There are, however, exceptions (a) in favour of companies who lend money in the ordinary course of their business; and (b) in favour of the provision of money for the purchase of, or subscription for, fully paid shares by trustees, if the shares are to be held by or for the benefit of employees, including directors holding salaried positions; and (c) in favour of loans of money to persons (other than directors) in the employment of the company with a view to enabling them to purchase fully-paid shares in the company to be held by themselves by way of beneficial ownership. Where advantage is taken of provisos (b) or (c) noted above, the total amount of any outstanding loans so made must, by paragraph 8 (1) (c), be shown as a separate item in the balance sheet.

Debentures held by nominee or trustee. Paragraph 10 of the Eighth Schedule provides that where any of the company's debentures are held by a nominee of or trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the company's books shall be stated.

Loans to officers. By Section 197 of the Act, the accounts which are to be laid before the company in general meeting must contain certain particulars of loans to officers.

It is necessary to show loans to officers, outstanding at the end of the financial year, made by the company itself, or by a subsidiary of the company, or by any other person under a guarantee from or on a security provided by the company itself or a subsidiary of the company. The requirement applies not only to a loan to a person who was an officer at the time the loan was made, but also to any loan made to a person who, after the making of the loan, became, during the financial year to which the accounts relate, an officer of the company. If the loan was made during the financial year in question, any amount repaid must be shown. It is not, however, necessary to disclose a loan made at a date earlier than the financial year in question unless it is still outstanding at the end of the financial year. If a loan made at an earlier date is repaid during the financial year, no particulars are required.

The requirements of Section 197 do not apply to:

- '(a) a loan made in the ordinary course of its business by the company or a subsidiary thereof, where the ordinary business of the company or, as the case may be, the subsidiary, includes the lending of money; or
- '(b) a loan made by the company or a subsidiary thereof to an employee of the company or subsidiary, as the case may be, if the loan does not exceed £2,000, and is certified by the directors of the company or subsidiary, as the case may be, to have been made in accordance with any practice

adopted or about to be adopted by the company or subsidiary with respect to loans to its employees; not being, in either case, a loan made by the company under a guarantee from or on a security provided by a subsidiary thereof or a loan made by a subsidiary of the company under a guarantee from or on a security provided by the company or any other subsidiary thereof.'

Thus, even though a loan is in other respects qualified for exception from the requirements as to disclosure, it must nevertheless be disclosed if it is made by one member of a group of companies under a guarantee from or on a security provided by another member of the group.

It is to be noted that, by Section 455 of the Act, the expression 'officer' includes a director, manager or secretary.

As to the method of giving the required information, it will usually be convenient to give particulars of loans made by the company itself in the balance sheet; in the case of loans made by a subsidiary or by any other person, the information will be given by way of a note.

In the event of the required information not being given, it is the duty of the auditors to include in their report, so far as they are reasonably able to do so, a statement giving the required particulars.

It is relevant to observe at this point that, subject to certain exceptions, Section 190 of the Act prohibits loans to directors. There is no prohibition of loans to officers other than directors, and the Act does not compel the repayment of loans made to directors before the Act came into operation, i.e. before 1st July, 1948.

The prohibition is in the following words:

'It shall not be lawful for a company to make a loan to any person who is its director or a director of its holding company, or to enter into any guarantee or provide any security in connection with a loan made to such a person as aforesaid by any other person.'

The prohibition does not apply:

- (1) to an exempt private company;
- (2) to a loan by a subsidiary company to its holding company, the holding company being a director of the subsidiary;
- (3) to a loan made in the ordinary course of business by a company whose ordinary business includes the lending of money or the giving of guarantees in connection with loans made by other persons;
- (4) to a loan made to a director for the purpose of meeting expenditure incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an officer of the company.

References in the above to loans include the entering into a guarantee and the provision of security. Exception (4) above is subject to the condition that either:

- (a) the prior approval of the company has been given at a general meeting at which the purposes of the expenditure and the amount of the loan or the extent of the guarantee or security, as the case may be, are disclosed; or
- (b) if the approval of the company is not given in the above manner at or before the next following annual general meeting, the loan

shall be repaid or the liability under the guarantee or security shall be discharged, as the case may be, within six months from the conclusion of that meeting.

Where the required approval of the company is not given, the directors authorising the making of the loan, or the entering into the guarantee, or the provision of the security, shall be jointly and severally liable to indemnify the company against any loss arising therefrom.

(c) **CURRENT ASSETS.** It is not, in general, necessary to disclose the basis or method of valuing current assets. But, 'if in the opinion of the directors any of the current assets have not a value, on realisation in the ordinary course of the company's business, at least equal to the amount at which they are stated, the fact that the directors are of that opinion' must be stated by way of note, or in a statement or report annexed to the balance sheet. Also, by paragraph 27 (2) of the Eighth Schedule, where any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess is to be treated as a reserve and not as a provision. It may also be observed that the provisions of the Eighth Schedule in regard to the profit and loss account include a requirement for the disclosure of any material respects in which any items shown in the profit and loss account are affected by any change in the basis of accounting.

It has been remarked above that the Act does not require the separate disclosure of any provision for diminution in value of current assets, but should such a provision have any exceptional significance the ruling principle of 'a true and fair view' must always be borne in mind.

Investments may be either fixed or current assets and the requirements of the Act in regard to the value of investments will therefore be considered in a later part of this chapter.

(d) **FIXED ASSETS.** Under the Companies Act, 1929, every balance sheet of a company was required to 'state how the values of the fixed assets have been arrived at'. It was not necessary to disclose either the original cost or the aggregate depreciation written off or provided since acquisition. The usual practice was to describe fixed assets in the balance sheet as being 'at cost less depreciation' without disclosing either the cost or the depreciation.

The principles adopted by the Cohen Committee on Company Law Amendment are clearly stated in the report:

'We consider that the proper course is to show the cost of the fixed assets in existence at the date of the balance sheet under appropriate headings and separately as a deduction therefrom the aggregate amount provided or written off for depreciation under each heading, though we recognise that this will not always be practicable or at any rate immediately practicable in the case of companies which bought an existing business for a lump sum or where adequate inventories and other records are not available to enable the figures to be separately stated. If proper records of newly acquired assets are

maintained in future, a statement in the form we think desirable should in most cases be practicable when the old assets have been replaced. In the case of certain fixed assets, such as loose tools, which are subject to renewal within comparatively short periods, it is not always practicable to ascertain in detail the cost and depreciation of the specific assets in existence. Where it is not practicable, we think that assets of this nature should appear in the balance sheet at a valuation. It is, however, the recognised practice of many companies carrying on the business of public utility undertakings to follow the practice adopted by some companies incorporated under special Acts of Parliament and to provide for the replacement of their fixed assets either by the establishment of renewal reserves against which is charged the cost of replacing assets, or by charging the cost of replacement direct to revenue; we cannot see our way to recommending the abolition of this practice so far as public utility companies are concerned since so many of them are not governed by the Companies Act. That being so, we do not think it practicable to require a statement of fixed assets in the balance sheets of public utility companies in the same manner as we suggest such statements should appear in the balance sheets of other companies.

(1) *Cost or valuation and aggregate depreciation.* Fixed assets must be stated in the balance sheet in accordance with paragraph 5 of the Eighth Schedule.

Sub-paragraphs (1) and (3) of paragraph 5 are as follows:

'(1) The method of arriving at the amount of any fixed asset shall, subject to the next following sub-paragraph, be to take the difference between—

(a) its cost or, if it stands in the company's books at a valuation, the amount of the valuation; and

(b) the aggregate amount provided or written off since the date of acquisition or valuation, as the case may be, for depreciation or diminution in value, and for the purposes of this paragraph the net amount at which any assets stand in the company's books at the commencement of this Act (after deducting the amounts previously provided or written off for depreciation or diminution in value) shall, if the figures relating to the period before the commencement of this Act cannot be obtained without unreasonable expense or delay, be treated as if it were the amount of a valuation of these assets made at the commencement of this Act, and, where any of those assets are sold, the said net amount less the amount of the sales shall be treated as if it were the amount of a valuation so made of the remaining assets

'(3) For the assets under each heading whose amount is arrived at in accordance with sub-paragraph (1) of this paragraph, there shall be shown—

(a) the aggregate of the amounts referred to in paragraph (a) of that sub-paragraph; and

(b) the aggregate of the amounts referred to in paragraph (b) thereof.'

The normal method of stating fixed assets in the balance sheet is thus to show both the cost and the accumulated amount written off or provided for depreciation; the difference between the two, representing the book value of the assets, may then be shown in the main column of the right-hand side of the balance sheet.

Some companies have, in the past, adopted the practice of making a 'global' provision for depreciation to cover all fixed assets without distinguishing between the various asset headings. This practice is no longer permissible, and, in the opinion of counsel, the directors must allocate the depreciation over the asset headings. (See I.C.A., paragraph 83.)

It was recognised that, apart from cases where the necessary figures for cost and depreciation are not obtainable without unreasonable

expense or delay, there will also be cases in which a company has revalued its fixed assets without reference to their original cost, as, for example, in connection with a scheme of reconstruction. In such cases, it appears reasonable to adopt such a valuation as the starting-point for purposes of disclosure in the balance sheet. This was recognised by the Cohen Committee, and the report recommends that 'when a company has adopted for purposes of its accounts a valuation of fixed assets such valuation shall be substituted for the amount previously attributed to such fixed assets, and the date of the valuation shall be stated'. Paragraph 5 (1) (a) of the Eighth Schedule accordingly provides that if a fixed asset stands in the company's books at a valuation, such valuation is to 'be substituted for cost. It is pointed out in the booklet on the Companies Act issued by the Institute of Chartered Accountants that the Act does not define 'valuation', or state who shall be competent to value. (I.C.A., paragraph 107.) It may be added that the Act does not incorporate the recommendation of the Cohen Committee that the date of valuation shall be stated. The Council of the Institute has nevertheless recommended that 'to satisfy the general requirement to show a true and fair view, an indication of the date and source of valuation should wherever practicable be given in the balance sheet'. (I.C.A., paragraph 78 (a).)

(2) *Net book amount basis.* Where the normal basis of cost or valuation and aggregate depreciation cannot be used because the figures relating to periods before 1st July, 1948 (the date of the commencement of the Act), cannot be obtained without unreasonable expense or delay, the Act provides for an alternative method. In such circumstances, the net amount at which any assets stand in the company's books on 1st July, 1948, is to be treated as if it were a valuation made on that date. The 'net amount' means the book figure, after deduction of amounts previously written off or provided for depreciation. If any of the assets have been sold, the amount of the sales must also be deducted in arriving at the amount which is to be treated as a valuation. It has become the custom to describe this method as the 'net book amount' basis.

If the cost or valuation is known for some assets of a particular class but cannot be obtained for others of that class, this does not justify the adoption of the net book amount basis for all assets under that heading. In such a case, it is necessary to state on the balance sheet the aggregate of (a) cost or valuation of those items for which the figures are available, and (b) the net book amount of those items for which the figures of cost or independent valuation are not available. The Act does not prescribe the separate disclosure of the two parts of this aggregate, and in the opinion of counsel it is sufficient to show one aggregate figure including both cost or valuation and net book amount. It is suggested, however, in the booklet of the Institute on the Companies Act (I.C.A., paragraph 68) that separate disclosure of the two parts 'will usually give a fairer view of the assets than is the case where one total only is shown, and it approaches nearest to

the intention behind the requirement to show cost less accumulated provisions'. If one aggregate figure is shown without distinguishing between cost or valuation and net book amount, it is certainly desirable, though possibly not strictly necessary in law, that the description of the aggregate figure should be suitably worded so as to indicate that part of the aggregate is at cost or independent valuation and part is at net book amount. The recommendation of the Council is that 'the description "valuation" should not be applied to any assets dealt with on the net book amount basis unless it is made clear that it is a notional valuation adopted in accordance with the requirements of the Act'. (I.C.A., paragraph 78 (b).)

The aggregate depreciation to be shown in the balance sheet is the amount written off or provided since the date of acquisition or valuation, as the case may be. Thus, if the net book amount basis is adopted, depreciation written off or provided after 1st July, 1948, must be stated. If a class of assets is brought in partly at cost or valuation and partly at net book amount, the depreciation which must be disclosed is the aggregate depreciation written off or provided (a) since the date of acquisition or valuation in respect of assets included in the total at cost or valuation, and (b) since 1st July, 1948, in respect of assets included in the total at net book amount. It is not necessary to distinguish between the two elements of the total depreciation; in the opinion of counsel, it is sufficient to show one aggregate deduction for depreciation. It is nevertheless desirable to show separately the two parts of the aggregate depreciation figure.

On a strict interpretation of paragraph 5 (1) of the Eighth Schedule, the net book amount is the amount at which the asset stands in the company's books on 1st July, 1948. It is, nevertheless, more convenient, in practice, to take the net book amount on the date of the balance sheet next before 1st July 1948, as the figure to be included in the balance sheet. This has been the usual practice in cases where the net book amount basis has been adopted. In many cases, even though it may not be possible to ascertain the amount of original cost or independent valuation, the book value of assets at a period considerably earlier than 1st July, 1948, may be available. Where this is so, more information will be given if the assets are shown in the balance sheet at their book value on an earlier date, with the aggregate depreciation since that date, than if they are brought in at the net book amount on 1st July, 1948. The terms of the Act do not appear to permit such a method of presentation but there can hardly be any serious objection to a method which is so clearly in accord with the principle of a true and fair view.

It has been observed that by paragraph 5 (1) of the Eighth Schedule, where any of the assets treated on the net book amount basis have been sold, the amount of the sales must be deducted from the net amount in arriving at the amount to be treated as a valuation on 1st July, 1948. This appears to mean that the proceeds of sale must be deducted. It is pointed out in the booklet of the Institute on the Companies Act (I.C.A., paragraph 79) that 'the remaining net book amount will usually be distorted as the proceeds of sale are rarely the

same as the figure which is included in the net book amount—in fact with the rise in price levels the proceeds may well be considerably greater'. The Council has therefore made the following recommendation:

'Wherever possible, on the sale of an asset which forms part of a notional valuation, the year in which it was acquired (or valued) and its cost (or valuation) should be closely estimated. Any surplus or deficit on the net book amount should then be dealt with in the same manner as is adopted in the case of the assets which are shown in the balance sheet at their cost or valuation.' (I.C.A., paragraph 80.)

In effect, it is recommended that, in accordance with normal accountancy methods, any profit or loss on sale should be eliminated. Such treatment, though not in accordance with the strict letter of the Act, is in accordance with the principle of a true and fair view.

The adoption of the net book amount basis is permitted where figures relating to the period before 1st July, 1948, cannot be obtained without unreasonable expense or delay. A company which adopts the net book amount basis for any of its assets is not, however, thereby released from the obligation of keeping such records for subsequent periods as will enable the normal basis to be adopted for assets acquired after 1st July, 1948. In the opinion of counsel, the words of Section 147 (1), by which a company is required to keep proper books of account, are mandatory, and the accounting records must be kept in such a way as to enable the company (except in so far as this would involve unreasonable expense or delay) to adopt the 'normal basis' of arriving at the amount of its fixed assets. (See I.C.A., paragraph 71.)

In the passage from the report of the Cohen Committee, quoted above, it was recognised that, in the case of certain fixed assets, such as loose tools, it is not always practicable to ascertain in detail the cost and depreciation of the specific assets in existence. This difficulty will be encountered in the case of assets acquired after 1st July, 1948, as well as in the case of assets acquired before that date. It is, therefore, provided by sub-paragraph 5 (2) (a) of the Eighth Schedule that the normal method of showing cost or valuation and aggregate depreciation shall not apply 'to assets for which the figures relating to the period beginning with the commencement of this Act cannot be obtained without unreasonable expense or delay'. In the opinion of counsel, sub-paragraph 5 (2) (a) can only refer to assets acquired on or after the 1st July, 1948. (I.C.A., paragraph 73.)

In view of the requirement of Section 147 (1) that companies shall keep proper books of account, the relaxation permitted in regard to assets acquired on or after 1st July, 1948, will apply only in exceptional cases. The relaxation by which the net book amount basis may be adopted for assets acquired before 1st July, 1948, will naturally have a far wider application, since the absence or paucity of records will in a large number of cases make it impossible to adopt the normal basis. For periods after 1st July, 1948, companies should keep such records as will enable them to adopt the normal basis, and it is only where the nature of the asset or some unusual circumstances make this impossible without unreasonable expense or delay that the requirement will be relaxed.

It is considered that the normal method will not be required in the

case of loose tools acquired after 1st July, 1948, or in the case of a group of assets purchased after 1st July, 1948, at an inclusive price without any values being attributed to the individual items. (I.C.A., paragraph 74.)

In the opinion of counsel, the net book amount basis can be used for assets acquired after 1st July, 1948, in cases where the normal basis would involve unreasonable expense or delay. Counsel also express the opinion that in such cases the net book amount of assets acquired after 1st July, 1948, may be amalgamated, in the balance sheet, with other assets under the same heading which are brought in at the net book amount at 1st July, 1948, and they suggest that appropriate words such as 'plus additions' should be added to the wording in the balance sheet. (I.C.A., paragraph 75.) It will be remembered that, by paragraph 5 (1) of the Eighth Schedule, the net book amount is to be treated as a valuation. The Council of the Institute has therefore made the following recommendation in regard to assets acquired on or after 1st July, 1948, in regard to which the normal method cannot be used.

'Where a group of assets is acquired at an inclusive price, a value should be allocated to each asset or class of asset by the directors or other competent person in such a manner as to enable the various assets or classes of assets to be shown in the balance sheet at "a valuation" and depreciation provided thereon.' (I.C.A., paragraph 76.)

Assets such as loose tools will usually be shown, following normal accounting practice, at a valuation as at the date of the balance sheet. This may be regarded as the net book amount on that date.

(3) *Public utility undertakings.* In the passage from the report of the Cohen Committee quoted above, reference was made to the common practice of public utility undertakings, by which an account is set up for provision for renewals, the cost of replacement being charged thereto. Alternatively, the cost of replacement is sometimes charged direct to revenue. If either of these methods is adopted, fixed assets may be represented in the balance sheet by the cost of the original (discarded) assets, which they have replaced. The Committee felt unable to recommend the abolition of this practice, and recommended that public utility undertakings should be exempt from the requirement to show cost or valuation and aggregate depreciation.

Public utility undertakings are not specifically mentioned in the Eighth Schedule, but the exemption recommended by the Committee is given in sub-paragraph 5 (2) (b) which provides that the requirements of paragraph 5 (1) shall not apply

'to assets the replacement of which is provided for wholly or partly—

(1) by making provision for renewals and charging the cost of replacement against the provision so made; or

(2) by charging the cost of replacement direct to revenue.'

If either of these methods is adopted, it is necessary to comply with the requirements of sub-paragraph 5 (4) which provides that in regard to such assets there shall be stated—

'(a) the means by which their replacement is provided for; and

(b) the aggregate amount of the provision (if any) made for renewals and not used.'

Thus if a company adopts the method of charging the cost of replacement against a provision for renewals or direct to revenue, the fact must be disclosed.

The Council of the Institute has also recommended that 'where provision is made for renewals instead of provision for depreciation, the accumulated amount of provision for renewals, so far as not used, should be shown separately in the balance sheet'. (I.C.A., paragraph 91.) It is considered that sub-paragraph 5 (4) (b) does not imply that such provisions must be deducted from the asset account.

If an amount is set aside for the purpose of financing the replacement of assets at an increased price level without the intention of charging the cost of replacement against it, the amount set aside would, in the opinion of counsel, be a reserve and not a provision. (See I.C.A., paragraph 92.) As mentioned above, the Council of the Institute has recommended that such a reserve should be treated as a specific capital reserve. On the other hand, if a provision for renewals is based on estimated replacement cost, and it is intended to charge the whole cost of replacement against it, the amount so set aside can apparently be described as a provision, even though estimated replacement cost is higher than the cost of the asset which it is intended to replace.

The drawback, from the standpoint of normal accounting practice, of charging cost of replacement against a provision for renewals or direct to revenue, is that an asset may be represented in the balance sheet by the cost of the original asset which has been replaced. The cost of the original asset may well have been much less than the cost of the asset actually in use. In such cases, it will be appropriate to include in the description of the asset on the balance sheet an indication that it represents the cost of the original asset, and that the cost of replacement has been charged against a provision for renewals or direct to revenue. This information must, in any event, be given, in accordance with sub-paragraph 5 (4) (b) of the Eighth Schedule, and it appears suitable to include it in the description of the asset.

(4) *Excessive provisions.* By sub-paragraph 27 (2) of the Eighth Schedule, where any amount written off or retained by way of providing for depreciation, renewals, or diminution in value of assets, not being an amount written off in relation to fixed assets before 1st July, 1948, is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess is to be treated as a reserve and not as a provision.

The classification of excessive provisions as reserves is designed to prevent the creation of secret reserves by making excessive provision for depreciation.

It is not easy, in practice, to determine precisely how much is reasonably necessary for depreciation. The working life of a fixed asset cannot always be predetermined with complete accuracy, and it is often necessary to revise estimates in the light of experience. The conclusion to be drawn from the opinion of counsel (I.C.A., paragraph 85) is that the terms of sub-paragraph 27 (2) are not to

be interpreted in such a way as to make decisions on this point unduly onerous. In the opinion of counsel, if the rate of depreciation adopted is 'one currently acceptable as proper for that kind of plant, it is not . . . necessary to value such plant as at the date of each balance sheet to ascertain whether to date there has been over or under provision'. On the other hand, a conscious and deliberate writing-down or retention in respect of anticipated future depreciation must clearly be treated as a reserve.

It may be found, after a periodic revision of the estimate of the expected useful life of an asset, that past provisions for depreciation have been somewhat larger than is necessary. If the past provisions were considered reasonable at the time they were made and the excessive provision is not too great in amount, it may not be necessary to treat the excess as a reserve. It may be sufficient to do no more than reduce subsequent provisions for depreciation by an amount which corresponds in total to the excessive provisions of the past, and in this way the asset is amortised at the end of its working life. On the other hand, if the excessive provision of the past is very large in amount or if it is the result of deliberate policy, the excess is clearly a reserve. Having transferred the excess to a reserve account, subsequent charges to profit and loss account for depreciation may then properly be treated as provisions.

The requirement that excessive provision for depreciation should be treated as a reserve is subject to a curious exception. By subparagraph 27 (2) of the Eighth Schedule, the excessive provision for depreciation to be so treated is, 'any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets *not being an amount written off in relation to fixed assets before the commencement of this Act*'. It will be noted that the exception applies to amounts '*written off*' before 1st July, 1948, and not to amounts '*retained*' before that date. It is observed in the booklet of the Institute on the Companies Act that the distinction normally understood between 'written off' and 'retained' is that 'written off' implies a deduction from the balance of the asset account in the books, leaving a net amount, whereas 'retained' implies the setting up of a separate account for the accumulation of depreciation provisions to be deducted in total in the balance sheet. (I.C.A., paragraph 86.) It is anomalous that excessive amounts 'retained' before 1st July, 1948, must be treated as reserves, while excessive amounts 'written off' before that date need not be so treated. It may be that the distinction is founded on the view that excessive amounts written off before 1st July, 1948, cannot be ascertained. While this is no doubt true in some cases, it is not true in all cases. There seems to be no good reason why excessive amounts written off before 1st July, 1948, if they can be ascertained, should not be transferred to a reserve account, even though the law does not require it. In the opinion of counsel if such an excessive amount is written back, it must be treated as a reserve. (See I.C.A., paragraph 87.) In any event, if such excessive provisions are not written back, it appears that any amounts subsequently set aside would have to be treated as a reserve until the total

of the amounts written off and set aside is no longer in excess of requirements. Such is the opinion of Counsel. (See I.C.A., paragraph 90.)

(5) *Goodwill, investments, preliminary expenses, expenses, commissions and discounts on the issue of shares and debentures.* The following are specifically excepted from the requirement to disclose cost and aggregate depreciation:

- '(i) any investments of which the market value (or, in the case of investments not having a market value, their value as estimated by the directors) is shown either as the amount of the investments or by way of a note.' (Paragraph 5 (2) (c) of the Eighth Schedule.)
- '(ii) Goodwill, patents or trade-marks.' (Paragraph 5 (2) (d) of the Eighth Schedule.)

If the market value of an investment (or value as estimated by the directors) is not stated, and the investment is held as a fixed asset, the cost or valuation and the aggregate of the amount provided for depreciation or diminution in value must be stated.

It has been observed in an earlier part of this chapter that preliminary expenses and expenses, commissions and discounts on the issue of shares and debentures must, by paragraph 3 of the Eighth Schedule, be stated in the balance sheet under the five separate headings prescribed in that paragraph. This requirement, as noted above, is subject to the qualification 'so far as they are not written off'. There is therefore no necessity to show the cost and aggregate amount written off in respect of these items.

(e) **VALUE OF INVESTMENTS.** By paragraph 11 (8) of the Eighth Schedule, it is necessary to state by way of a note, or in a statement or report annexed to the balance sheet, if not otherwise shown—

'the aggregate market value of the company's quoted investments, other than trade investments, where it differs from the amount of the investments as stated, and the stock exchange value of any investments of which the market value is shown (whether separately or not) and is taken as being higher than their stock exchange value.'

It will be noted that the above does not apply to all investments.

Investments which are held as fixed assets and of which the market value or value as estimated by the directors is not shown are bound by the rules of paragraph 5 just as any other fixed assets. If they are held as current assets, paragraph 11 (7) applies, i.e. if, in the opinion of the directors, their realisable value is less than the amount at which they are stated, it is necessary to disclose the fact that the directors are of that opinion.

(f) **COMPARATIVE FIGURES.** Except in the case of the first balance sheet laid before the company after 1st July, 1948, the balance sheet must include the corresponding amounts at the end of the immediately preceding financial year for all items shown in the balance sheet. (Paragraph 11 (11) of the Eighth Schedule.)

The most convenient method of giving this information is to show the comparative figures in a column or columns to the left of the descriptive matter on each side of the balance sheet.

If, however, the principal part of the balance sheet contains a number of inner columns to accommodate details and sub-headings, it may be found that the provision of a corresponding number of columns for the previous year's figures will make the balance sheet an unwieldy and cumbersome document. A solution of this difficulty is to show some details in schedules; the balance sheet itself then becomes a relatively simple document.

It is hardly necessary to say that the comparative figures are of very great value. By comparing each item in the balance sheet with the corresponding amount for the previous year, the significance of the figures can more readily be appreciated and understood.

DIRECTORS' REPORT. In paragraph 11 of the Eighth Schedule, to which reference has been made above in connection with a number of matters, it is provided that the required information may be stated by way of note, or in a statement or report annexed, if not otherwise shown, i.e. if not shown in the main part of the balance sheet.

Section 163 provides as follows:

'References in this Act to a document annexed or required to be annexed to a company's accounts or any of them shall not include the directors' report or the auditors' report:

Provided that any information which is required by this Act to be given in accounts, and is thereby allowed to be given in a statement annexed, may be given in the directors' report instead of in the accounts and, if any such information is so given, the report shall be annexed to the accounts and this Act shall apply in relation thereto accordingly, except that the auditors shall report thereon only so far as it gives the said information.'

It follows that the information required by paragraph 11 of the Eighth Schedule may be given in the directors' report.

The following is a brief summary of the matters covered by paragraph 11:

- (1) Options on shares.
- (2) Arrears of fixed cumulative dividends.
- (3) Charges on assets to secure the liabilities of any other person.
- (4) Contingent liabilities.
- (5) Capital commitments.
- (6) Realisable value of current assets.
- (7) Market value of quoted investments other than trade investments.
- (8) Basis of conversion of foreign currencies.
- (9) Basis of computing amount set aside for United Kingdom income-tax.
- (10) Comparative figures for previous year.

OVERSEAS BRANCHES. Section 149 (1) provides that every balance sheet of a company shall give a true and fair view of the state of affairs of the company *as at the end of its financial year*, and every profit and loss account of a company shall give a true and fair view of the profit or loss of the company *for the financial year*.

It is pointed out, in paragraph 134 of the Institute's booklet on the Companies Act, that it is a not unusual practice, in the case of com-

panies with overseas branches, to include in their accounts branch accounts made up to a date prior to the end of the company's financial year, this practice being adopted in order to avoid delay in the presentation of the company's accounts.

It appears that this practice cannot be reconciled with the requirements of Section 149 (1). In the opinion of counsel, it is imperative that accounts from branches abroad should be made up to the close of the financial year of the company for the purpose of inclusion in the company's accounts.

II. THE PROFIT AND LOSS ACCOUNT

In paragraph 96 of the report of the Cohen Committee on Company Law Amendment, it is remarked that, under the Act of 1929, there were no requirements as to the form of the profit and loss account. The report adds:

'We consider that the profit and loss account is as important as, if not more important than, the balance sheet, since the trend of profits is the best indication of the prosperity of the company and the value of the assets depends largely on the maintenance of the business as a going concern.'

and in paragraph 103:

'We consider that the laws should lay down minimum requirements as to the contents of the profit and loss, or income and expenditure, account calculated to ensure that it gives a fair indication of the earnings of the period covered by the accounts and that the auditor should be under specific responsibility to report on its contents. The account should be drawn up in accordance with accepted accountancy principles consistently maintained and if for any reason any change of a material nature, e.g. a change in the basis of stock valuation, is adopted, specific attention should be called to the change and to the effect thereof.'

A TRUE AND FAIR VIEW. The principles laid down in the report of the Cohen Committee in regard to the profit and loss account have received statutory recognition in Section 149 (1) of the Act and in the requirements of paragraphs 12 to 14 of the Eighth Schedule.

By Section 149 (1)—

'Every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year.'

The expression 'profit and loss account' includes the income and expenditure account of a company not trading for profit. (See Section 149 (7) (b).)

The various requirements of the Eighth Schedule in regard to the profit and loss account are considered below. At this point, it will be useful to consider, in conjunction with Section 149 (1), the requirement of paragraph 14 (6) of the Schedule, by which it is necessary to state by way of note, if not otherwise shown:

'Any material respects in which any items shown in the profit and loss account are affected—

- (a) by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or
- (b) by any change in the basis of accounting.'

The auditors of a company are required, by Section 162 (1), to report on the profit and loss account, and are required, by the Ninth

Schedule, to state whether, in their opinion and to the best of their information and according to the explanations given them, the profit and loss account gives a true and fair view of the profit or loss of the financial year.

In connection with this important new duty placed on the auditors, the Council of the Institute has drawn attention to paragraph 17 of the Council's published recommendation No. VIII on the form of balance sheet and profit and loss account, viz.:

'The disclosure of the results of the period "implies substantial uniformity in the accounting principles applied as between successive accounting periods; any change of a material nature, such as a variation in the basis of stock valuation or in the method of providing for depreciation or taxation, should be disclosed if its effect distorts the results. The account should disclose any material respects in which it includes extraneous or non-recurrent items or those of an exceptional nature, and should also refer to the omission of any item relative to, or the inclusion of any item not relative to, the results of the period".' (I.C.A., paragraph 136.)

Although the directors' report is not part of the profit and loss account, the requirement of Section 157 (2) in regard to the directors' report may appropriately be considered at this point.

By Section 157 (2):

'The said report shall deal, so far as is material for the appreciation of the state of the company's affairs by its members and will not in the directors' opinion be harmful to the business of the company or of any of its subsidiaries, with any change during the financial year in the nature of the company's business, or in the company's subsidiaries, or in the classes of business in which the company has an interest, whether as member of another company or otherwise.'

DEPRECIATION OF FIXED ASSETS. It is necessary to show as a separate item in the profit and loss account 'the amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets'. (Paragraph 12 (1) (a), Eighth Schedule.) It is also necessary to state by way of note, if not otherwise shown:

'If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for or the fact that it is not provided for, as the case may be.' (Paragraph 14 (2), Eighth Schedule.)

In the opinion of counsel, a statement in accordance with paragraph 14 (2) is necessary, if depreciation or replacement of any fixed asset or class of such assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for. (See I.C.A., paragraph 82.) Thus the normal treatment of some of the fixed assets does not appear to relieve a company from the obligation to make the required statement in regard to any asset or class of assets which is not treated in the normal manner. Counsel also remark that 'absurd as it may seem, there is no exception in the case of freehold land'. (I.C.A., paragraph 82.)

It has been observed above, in connection with the method of stating fixed assets in the balance sheet, that, if past provisions for depreciation have been excessive, and the amount of the excess is not too great, the matter may be adjusted by reducing subsequent provisions for depreciation rather than by transferring the excessive past provisions to a reserve. If the provision for depreciation is reduced, for this

reason, below the normal amount, the profits of the period will be overstated. It is thought that the overriding requirement to present a true and fair view makes it necessary to disclose this by way of note.

Some companies have increased the initial depreciation charge on plant and machinery to the extent of the initial allowance for taxation purposes. This treatment cannot be regarded as good accounting, since it distorts the profit of the period by charging revenue with an amount which is out of proportion to that part of the working life of the asset which has expired. The Council of the Institute has recommended that normal methods of depreciation should be maintained. If, however, a company adjusts the depreciation charge so as to relate it to the allowances for taxation purposes, it appears to be necessary to indicate by means of a note the treatment that has been adopted.

DIRECTORS' EMOLUMENTS. The report of the Cohen Committee recommended the full disclosure of the fees and other remuneration of directors.

The following extracts are taken from paragraph 90 of the report:

'We consider that full disclosure of the aggregate of directors' fees and, separately, of the aggregate of their other remuneration is desirable. . . .

'It seems to us right that the shareholders on whose behalf the directors are appointed to act, should know how much they are paid for their services. . . .

'The committee also consider it desirable that the amount of any expense allowances which are not in reimbursement of expenses actually incurred, should be included as part of the total emoluments disclosed to the shareholders. . . .

'The principle on which we are basing our recommendations is that since directors are normally responsible for fixing the remuneration of directors employed in executive capacities the amounts they themselves receive should be disclosed; this principle is not applicable to executives who are not directors. . . .

'By comparison of the total [emoluments] with the results of the company they [i.e. the shareholders] can form a rough estimate as to whether they are getting proper value out of the services as a whole.'

Section 196 of the Act contains very comprehensive requirements for the disclosure of directors' emoluments.

(1) *General effect of Section 196.* The general effect of Section 196 is to require the disclosure, either in the accounts or in an annexed statement, of three aggregates, each of which must be stated, viz.:

(a) Directors' emoluments.

(b) Directors' or past directors' pensions.

(c) Compensation to directors or past directors for loss of office.

In the case of (a) and (b) the aggregates to be disclosed include amounts receivable in respect of (i) services as director, and (ii) services while director of the company in connection with the management of the affairs of the company. As regards (c), the aggregate must include compensation for loss of office as director and compensation for loss of any other office in connection with the management of the company's affairs. In the case of each of these aggregates, it is necessary to distinguish between amounts receivable as director, and amounts receivable in connection with management.

The first two aggregates must include amounts receivable for services while director of the company as director of any subsidiary of the company or in connection with the management of the affairs

of any subsidiary. In the case of (c), the aggregate must include compensation for loss of office as director of any subsidiary or in connection with the management of any subsidiary, provided the loss of such office occurs while the person concerned is a director of the holding company or in connection with the termination of such directorship.

The amounts to be disclosed include sums paid by or receivable from:

- (i) the company;
- (ii) the company's subsidiaries; and
- (iii) any other person.

By Section 455, the expression 'director' includes any person occupying the position of director by whatever name called.

The above requirements leave little scope for evasion.

To ensure full and complete disclosure, it is provided by subsection (8) of Section 196 that

'if in the case of any accounts the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report thereon, so far as they are reasonably able to do so, a statement giving the required particulars.'

The requirements of the section are subject to the qualification contained in subsection (1), 'so far as the information is contained in the company's books and papers or the company has the right to obtain it from the persons concerned'.

The amounts to be shown under Section 196 for any financial year are the sums receivable in respect of that year whenever paid, or, in the case of sums not receivable in respect of a period, the sums paid during that year. The information required by Section 196 is to be given in the accounts or in a statement annexed thereto. The particulars may therefore be given, as permitted by Section 163, in the directors' report.

These requirements must now be examined in detail.

(2) *Emoluments*. It is provided by subsection (2) that the amount to be disclosed as directors' emoluments—

- '(a) shall include any emoluments paid to or receivable by any person in respect of his services as director of the company or in respect of his services, while director of the company, as director of any subsidiary thereof or otherwise in connection with the management of the affairs of the company or any subsidiary thereof; and
- (b) shall distinguish between emoluments in respect of services as director, whether of the company or its subsidiary, and other emoluments.'

The Act does not contain any definition of 'management'. In the opinion of counsel, emoluments in connection with the management of the affairs of the company means remuneration paid to a director for services in a managerial or executive capacity, e.g. as managing director, manager, secretary, or as a departmental head. It is observed that such remuneration would normally be paid under a service contract. (See I.C.A., paragraph 115.) It seems clear that 'services in connection with the management of the affairs of the company' does not include the services of persons who, although nominally directors, are employed in work of a junior or less responsible character. Neverthe-

less, there will be cases in which it will not be easy to draw a clear line of demarcation.

The apportionment of payments between services as director and services in connection with management will be considered below.

The expression 'emoluments', in relation to a director, includes—

- (a) fees and percentages;
- (b) any sums paid by way of expenses allowance in so far as those sums are charged to United Kingdom income-tax;
- (c) any contribution paid in respect of him under any pension scheme;
- (d) the estimated money value of any other benefits received by him otherwise than in cash.

If any sums paid by way of expenses allowance are charged to income-tax after the end of the relevant financial year, they must be shown in the first accounts in which it is practicable to show them or in a statement annexed thereto.

The meaning of (c) will be considered below in connection with pensions.

As regards benefits otherwise than in cash, the following examples are given in the Institute's booklet on the Companies Act. (I.C.A., paragraph 120):

- (i) The free use of living accommodation (possibly expensive flats or hotel accommodation).
- (ii) The use of motor-cars and the payment of all expenses in connection therewith.
- (iii) Goods and services of the kind supplied by the company, obtained without charge or at wholesale or other reduced prices.
- (iv) Regular luncheons.

This list is, of course, by no means exhaustive, and, in the opinion of counsel, if a director is entitled in his capacity as such to benefit under a trust of shares of the company, any dividends would be received by the director by virtue of his position as such, and would be emoluments. (I.C.A., paragraph 129.)

Some expenses may be incurred primarily for the benefit of the company and may yet benefit the director also. As an example, counsel mention the case of a managing director of a hotel who lives with his family in a flat in the hotel free of charge. In the opinion of counsel, although this would no doubt be a benefit to the company, it is also a benefit to the director and its value would be an emolument. (See I.C.A., paragraph 124.)

The valuation of benefits otherwise than in cash is often a matter of considerable difficulty. Certain benefits in kind, however, have become subject to income-tax, and the method of valuation prescribed in Section 40 of the Finance Act, 1948, may conveniently be adopted for the purpose of complying with Section 196 of the Companies Act.

It would be still more convenient if the requirements of Section 196 in this respect were explicitly confined to benefits otherwise than in cash which are charged to income-tax. An amendment of Section 196 in this sense has been suggested by the Council of the Institute in the memorandum submitted to the Board of Trade, dated 6th July, 1949.

(3) *Pensions.* It is necessary to disclose the aggregate of directors' and past directors' pensions. The amount to be disclosed must include any pension paid or receivable in respect of the services of a director or past director of the company as director, or in respect of his services, while director of the company, as director of any subsidiary thereof or otherwise in connection with the management of the company or any subsidiary.

It is also necessary to distinguish between pensions in respect of services as director and other pensions.

It is not necessary to disclose any pension paid or receivable under a pension scheme if the scheme is such that the contributions thereunder are substantially adequate for the maintenance of the scheme. The reason for this exception is that the company's contributions in respect of such pensions must be disclosed as emoluments in the year or years in which they were charged.

The pensions to be disclosed include not only those paid to or receivable by a director, or past director, but also those paid to any other person, on the nomination of, or by virtue of dependence on, or other connection with, a director or past director.

In the memorandum submitted to the Board of Trade by the Council of the Institute, dated 6th July, 1949, it is pointed out that, where a manager of a company retires on pension and is given a seat on the board of directors, it is not clear whether such a pension must be shown separately, and it is suggested that Section 196 should be amended so as to make it clear that such a pension does not fall within the section.

In subsection (3) (b) of Section 196, the following definitions are given:

- (a) 'Pension' includes any superannuation allowance, superannuation gratuity or similar payment.
- (b) 'Pension scheme' means a scheme for the provision of pensions in respect of services as director or otherwise which is maintained in whole or in part by means of contributions.
- (c) 'Contribution' in relation to a pension scheme means any payment (including an insurance premium) paid for the purposes of the scheme by or in respect of persons rendering services in respect of which pensions will or may become payable under the scheme, except that it does not include any payment in respect of two or more persons if the amount paid in respect of each of them is not ascertainable.

(4) *Compensation for loss of office.* The report of the Cohen Committee on Company Law Amendment drew attention to the practice of making payments to directors in connection with their retirement from office, or, in the case of directors holding other offices, in connection with their giving up such other offices. The report points out that this practice is on occasion abused, and cites the case of a contract entered into with a managing director with the very intention of terminating the contract and paying compensation in the form of capital and not of income. The report also

mentions the practice by which, on the sale of a company's undertaking or the acquisition of control by a third party by means of a purchase of shares, compensation for loss of office is paid to the company's directors by the purchaser and not by the company. The danger inherent in these practices needs no explanation.

By Section 191 of the Act, the approval of the company is required before any payment can be made by a company to any of its directors by way of compensation for loss of office or in consideration for or in connection with his retirement from office. Section 191 requires the approval of the company before any such payment can be made in connection with the transfer of the whole or any part of the undertaking or property of the company.

By Section 196, it is necessary to disclose the aggregate amount of any compensation to directors or past directors for loss of office.

By subsection (4) of Section 196, the amount to be disclosed—

- '(a) shall include any sums paid to or receivable by a director or past director by way of compensation for the loss of office as director of the company or for the loss, while director of the company or on or in connection with his ceasing to be a director of the company, of any other office in connection with the management of the company's affairs or of any office as director or otherwise in connection with the management of the affairs of any subsidiary thereof; and
- '(b) shall distinguish between compensation in respect of the office of director, whether of the company or its subsidiary, and compensation in respect of other offices.'

It is also provided that references to compensation for loss of office shall include sums paid as consideration for or in connection with a person's retirement from office.

It will be observed that in the case of each of the three aggregates, emoluments, pensions, and compensation for loss of office, it is necessary to distinguish between amounts receivable as director or in respect of the office of director, and other amounts. In all three cases, the amounts to be disclosed must include all relevant sums paid by or receivable from (i) the company, (ii) the company's subsidiaries, and (iii) any other person. It is only in the case of compensation for loss of office that it is necessary to show separately the amounts received from each of the three above-mentioned sources; the significance of this requirement becomes obvious if, in connection with the sale of a company's undertaking or the acquisition of control of the company by a third party by means of a purchase of shares, such compensation is paid to any of the company's directors by the purchaser.

(5) *Apportionment of payments.* It is not always easy in practice, to make the required distinction between amounts receivable as director and amounts receivable in connection with management. In the first place, a director may receive an inclusive remuneration in respect of his services both as a director and a manager, and, in the second place, the line between directorial and managerial functions cannot always be sharply drawn.

Subsection (7) of Section 196 provides for apportionment where necessary, as follows:

'Where it is necessary so to do for the purpose of making any distinction required by this section in any amount to be shown thereunder, the directors may apportion any payments between the matters in respect of which they have been paid or are receivable in such manner as they think appropriate.'

Although the power given to the directors by this subsection is permissive, in the opinion of counsel the directors must exercise the power if that is necessary in order that the accounts may give the information required by the section. (See I.C.A., paragraph 116.)

As to the distinction between directorial and managerial functions, in the opinion of counsel 'the conception seems to be that directors control the policy of the company, whereas managers carry out the decisions of the directors and take the action necessary to give effect to those decisions'. It is also remarked that 'the distinction is not easy to observe, since directors are inherently managers'. (I.C.A., paragraph 113.)

The difficulty may be resolved if remuneration for services as director and remuneration for services in connection with management are determined separately. Directors' fees, i.e. fees for services as directors, will usually be fixed either by the articles of association or by the company in general meeting, while remuneration for services in connection with management will frequently be fixed by a service contract.

(6) *Sources of emoluments, pensions and compensation for loss of office.* It has been observed above that the amounts to be disclosed under Section 196 include all relevant sums paid by or receivable from (i) the company, (ii) the company's subsidiaries, and (iii) any other person.

The expression 'any other person' will include a purchaser of the company's undertaking or a person who acquires control of the company by means of a purchase of shares who pays to any of the directors compensation for loss of office. As noted above, in the case of compensation for loss of office, it is necessary to disclose separately the amount from each of the three sources.

In the opinion of counsel, the expression 'any other person' includes, for the purpose of the accounts of a subsidiary company, its holding company or any other company in the group. It follows that if a director of a holding company is also a director of a subsidiary, and the whole of his remuneration for his services to both companies is paid and borne by the holding company, the whole sum must, unless apportioned, be disclosed in the accounts (or annexed statement) of both companies. (See I.C.A., paragraph 127.) It is hardly necessary to remark that the whole sum, even if apportioned by the holding company, must be disclosed in the accounts of the holding company, but, in such event, it is only necessary to disclose in the subsidiary's accounts the amount apportioned in respect of services as director of the subsidiary. Counsel also cite, as a further example, the case of a director who is paid £1,000 by a holding company for services as a director of the holding company and four subsidiaries, and express the opinion that if the sum is not apportioned by the holding company,

then the holding company and each subsidiary would be bound to show this sum (i.e. £1,000), either in the accounts or in a statement annexed thereto. (I.C.A., paragraph 127.)

(7) *The auditor's duty.* By subsection (8) of Section 196:

'If in the case of any accounts the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report thereon, so far as they are reasonably able to do so, a statement giving the required particulars.'

The duty so imposed on auditors may on occasion be a very onerous one, and particularly so in regard to benefits received by a director otherwise than in cash. In the opinion of counsel, it is the duty of the auditor to make enquiry from the company and from the directors in order that he may verify the benefits obtained by the directors otherwise than in cash. (I.C.A., paragraph 122.) Counsel were also of the opinion that, in order to place himself in a position to perform his duties, an auditor should obtain an assurance from the directors that no benefits had been received otherwise than in cash or alternatively, a statement of such benefits. Directors are required by Section 198 (1) to give such notice to the company of certain matters as may be necessary for compliance with certain requirements of the Act, including the requirements of Section 196 as to the disclosure of directors' emoluments, pensions and compensation. There is no statutory obligation, however, that the notice regarding emoluments, &c., should be given by the directors *in writing*. It is obvious that the auditor's task would be made easier if directors were required to give this information in writing. The Council of the Institute, in its memorandum to the Board of Trade, dated 6th July, 1949, has made the following suggestions:

'It is desirable that subsection (1) of Section 198 should be amended so that a notice *in writing* shall be required from each director covering all pensions, compensation and emoluments including all benefits received otherwise than in cash.'

Apart from the requirements of Section 198 (1), the auditor is, by Section 162 (3), 'entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of the duties of the auditors'. It would seem that these powers are sufficient to enable the auditor to require that the information necessary for compliance with Section 196 should be given in writing. The Council of the Institute has made the following recommendation:

'Where the notice to be given by each director under Section 41 (1) [now Section 198 (1) of the Companies Act, 1948] is not given in writing in the form of a statement of pensions, compensation and emoluments, including all benefits received otherwise than in cash, approved by the board and recorded in the minutes, the auditor should require (under clause 162 (3) of the consolidating Companies Bill, 1948) [now Section 162 (3) of the Companies Act, 1948] such a statement in writing approved by resolution of the board.'

As to the valuation of benefits in kind, in the opinion of counsel the auditor must assess the value of the benefits to the best of his ability and satisfy himself that the value of benefits has been shown at a fair figure. (I.C.A., paragraph 122.)

It has been noted above, under 'emoluments', that certain benefits in kind have become subject to income-tax and that Section 40 of the Finance Act, 1948, prescribes methods of valuation. It has also been observed that the Council of the Institute has suggested that Section 196 should be amended so that benefits 'otherwise than in cash' relate only to benefits charged to United Kingdom income-tax.

(8) *Definition of a subsidiary.* If the director of a company is also a director of another body corporate by virtue of the company's direct or indirect nomination, then such a body corporate is, for purposes of Section 196, a subsidiary of the company, even though it may not be a subsidiary for other purposes.

TAXATION. By paragraph 12 (1) (c) of the Eighth Schedule, it is necessary to show—

'the amount of the charge for United Kingdom income-tax and other United Kingdom taxation on profits, including, where practicable, as United Kingdom income-tax any taxation imposed elsewhere to the extent of the relief, if any, from United Kingdom income-tax and distinguishing, where practicable between income-tax and other taxation.'

It is also necessary, by paragraph 14 (3), to state, by way of note if not otherwise shown, the basis on which the charge for United Kingdom income-tax is computed.

If a company follows the now usual practice of charging profit and loss account with future income-tax, based on the profits of the current year, and the company is also in receipt of income taxed by deduction, the total debit to profit and loss account in respect of income-tax will include two distinct elements, (a) tax on current investment income suffered by deduction, and (b) tax on current profits normally assessable under Schedule D for the fiscal year commencing after the date of the balance sheet. The first is properly described as a charge to profit and loss account, but the second is, in the opinion of counsel, a reserve. It is somewhat anomalous to include an amount which is apparently in law a reserve with the 'charge' for United Kingdom income-tax as required by paragraph 12 (1) (c). The most suitable treatment is to show the two elements separately in an inner column, the total debit for income-tax being extended. Alternatively, the amount set aside for future tax may be stated as part of the descriptive wording. Treatment on these lines appears to be necessary in order to comply with the requirement of paragraph 12 (1) (e) that amounts set aside to, or withdrawn from, reserves shall be shown. To comply fully with the requirements regarding withdrawals from reserves, it seems to be necessary to show the treatment of an amount set aside in a previous year for future income-tax. If the company's year ends, for example, on 31st March, an amount set aside at 31st March, 1948, for the future tax of 1948-49, will normally have been eliminated, by payment of the tax, before 31st March, 1949. If the company's year ends on some other date, e.g. 31st December, an amount set aside at 31st December, 1948, for the future tax of 1949-50, will normally represent a current liability at 31st December, 1949. Some indication of these

matters should be given either in the profit and loss account or by way of note. If the amount set aside proves to be excessive or deficient, the excess or deficit, if material, should be shown separately in the accounts.

The Council of the Institute of Chartered Accountants has expressed the opinion that if the charge for income-tax is materially affected by initial allowances under the Income Tax Act, 1945, the effect should be indicated. The Council has also expressed the opinion that the desirability or otherwise of transferring to reserve and spreading over a period of years the taxation benefit resulting from initial allowances is a matter of financial policy.

Paragraph 12 (1) (c) of the Eighth Schedule requires the inclusion, where practicable, as United Kingdom income-tax of any taxation imposed elsewhere to the extent of the relief, if any, from United Kingdom income-tax. It is anomalous that foreign or overseas taxation should be shown as United Kingdom income-tax, and the Council of the Institute, in its memorandum to the Board of Trade, dated 6th July, 1949, has suggested that in the above passage the word 'with' should be substituted for the word 'as'. The Council also points out that paragraph 12 (1) (c) does not include any reference to relief from United Kingdom profits tax, although in the taxation regulations now in force relief for overseas taxation is given first against profits tax. The Council suggests that the reference in paragraph 12 (1) (c) to relief from 'United Kingdom income-tax' should be amended to relief from 'United Kingdom taxation on profits'.

OTHER ITEMS TO BE SHOWN IN THE PROFIT AND LOSS ACCOUNT. In addition to the matters already described, the following must be shown in the profit and loss account:

(1) *Interest on debentures and fixed loans.* Disclosure of interest on debentures and other fixed loans is required by paragraph 12 (1) (b) of the Eighth Schedule. The Act does not contain any definition of 'fixed loan', but the definition of 'long-term' liabilities in No. VIII of the Recommendations on Accounting Principles may perhaps be appropriate. It is there stated that the expression 'long-term' is intended to cover liabilities not due for payment until after the lapse of one year from the date of the balance sheet. It is not necessary to disclose interest on a bank overdraft.

(2) *Amounts respectively provided for redemption of share capital and for redemption of loans.* (Paragraph 12 (1) (d), Eighth Schedule.) The word 'respectively' indicates that a capital redemption reserve fund, which must be set up when redeemable preference shares are redeemed otherwise than out of the proceeds of a new issue of shares, must be shown separately from any amounts provided for the redemption of loans.

(3) *Income from investments.* By paragraph 12 (1) (g) of the Eighth Schedule, it is necessary to show income from investments, distinguishing between income from trade investments and income from other investments.

In No. III of the Recommendations on Accounting Principles, it is recommended that income-tax on revenue taxed before receipt should be included as part of the taxation charge for the year and the relative income should be brought to credit gross.

(4) *The aggregate amount of dividends paid and proposed.* By paragraph 12 (1) (h) of the Eighth Schedule, it is necessary to show the aggregate amount of dividends paid and proposed, and by paragraph 14 (4) it is necessary to state whether or not the amount shown is subject to deduction of income-tax. By contrast, paragraph 8 (1) (e) requires the net aggregate amount (i.e. after deduction of income-tax) of proposed dividends to be shown in the balance sheet. The usual practice is to show the net amount of dividends paid and proposed in the profit and loss account in accordance with the Recommendations on Accounting Principles.

It is to be noted that the Act makes it compulsory to include proposed dividends in the profit and loss account and balance sheet.

(5) *Auditors' remuneration.* By paragraph 13 of the Eighth Schedule, the amount of the auditors' remuneration must be shown under a separate heading, unless it has been fixed by the company in general meeting. Any sums paid by the company in respect of auditors' expenses are to be included as part of the remuneration. This matter was considered in Chapter I, to which the reader is referred.

(6) *Movements in reserves and liability provisions.* The requirements of paragraph 12 (1) (e) and (f) in regard to the sources of increases and the application of decreases in reserves and liability provisions have been considered earlier in this chapter under the heading 'Reserves and Provisions'.

COMPARATIVE FIGURES. By paragraph 14 (5) of the Eighth Schedule, it is necessary to state the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account.

EXCEPTIONS FOR SPECIAL CLASSES OF COMPANY. BANKING, DISCOUNT AND ASSURANCE COMPANIES. The special circumstances of banking, discount and assurance companies were recognised in the report of the Cohen Committee on Company Law Amendment.

The following is an extract from paragraph 101 of the report, and it follows immediately after the passage quoted earlier in this chapter.

'There are, however, three classes of companies where other considerations must be taken into account, namely, banking companies, discount companies and assurance companies (we use the term "assurance companies" to cover both assurance and insurance companies). In the case of banking and assurance companies the interests of the depositors and the policy-holders respectively outweigh the interests of the shareholders and in the case of all three classes of companies considerations affecting the public interest must be taken into account. The reputation for stability of these companies is a national asset of the first importance to the community in general and it is not in the public interest to endanger their stability or the confidence they enjoy at home and abroad.

from time to time the values of their assets and particularly their very large holdings of Government and other gilt-edged securities are adversely affected by political disturbances and economic conditions, national and international. In such circumstances it is desirable that their financial strength should be even greater than may appear. The history of the years after 1929 demonstrates the public advantage of their being able to present a reasonably stable position in a time of violent and sudden stress and for this reason it seems to us desirable that such companies should be permitted to retain a buffer of undisclosed reserves. In this country no one questions the stability of our banks, discount companies and assurance companies, but some countries are not so happily placed and countries abroad watch the evidence of stability very closely and react very quickly to any unusual symptoms. We consider, therefore, that banking and discount companies should be absolved from the obligation of showing separately reserves and provisions and transfers to and from such accounts, but their balance sheets should indicate the existence of reserves and provisions and their profit and loss accounts should be appropriately worded so as to show whether any such transfers have been made during the period covered by the accounts.'

Definitions. By paragraph 23 (3) of the Eighth Schedule, 'the expression "banking or discount company" means any company which satisfies the Board of Trade that it ought to be treated for the purposes of this Schedule as a banking company or as a discount company.'

For purposes of the Eighth Schedule an assurance company is one which is such within the meaning of the Assurance Companies Acts, 1909 to 1946, and which is subject to and complies with the requirements of those Acts as respects the preparation and deposit with the Board of Trade of a balance sheet and profit and loss account.

Extent of exemption from requirements. Banking, discount and assurance companies are exempt from certain of the requirements of the Act in regard to the balance sheet and profit and loss account to the extent specified in paragraphs 23 and 24 of the Eighth Schedule.

All three classes of company are exempt from the requirements of the following paragraphs of the Eighth Schedule, to the extent specified:

(1) Paragraph 4 (except so far as it relates to fixed and current assets), and paragraphs 6 and 7. Thus it is not necessary to classify under headings appropriate to the company's business the reserves, provisions and liabilities. It is not necessary to state separately the aggregate amount of capital reserves, revenue reserves and liability provisions, nor is it necessary to give particulars of movements in reserves and liability provisions. The three classes of company are also exempt from the requirements of paragraph 12 (1) (e) and (f), and there is thus no necessity to give in the profit and loss account particulars of movements in reserves and liability provisions.

Nevertheless, paragraph 23 provides that where in the balance sheet 'capital reserves, revenue reserves or provisions (other than provisions for depreciation, renewals or diminution in value of assets) are not stated separately, any heading stating an amount arrived at after taking into account such a reserve or provision shall be so framed or marked as to indicate that fact, and its profit and loss account shall indicate by appropriate words the manner in which the amount stated for the company's profit or loss has been arrived at.'

(2) Paragraph 5. This paragraph provides for the method of arriving at the amount of any fixed asset. Companies of the three classes are therefore not required to state either the cost or valuation or aggregate

depreciation of any fixed asset. These companies are also exempt from the requirements of paragraph 12 (1) (a) and paragraph 14 (2), and it is thus not necessary to show in the profit and loss account the amount of provision for depreciation or to give any particulars of the method of providing for depreciation or replacement, or to disclose that no provision has been made.

It must be noted, however, that banking, discount and assurance companies are bound by the requirements of paragraph 4 relating to fixed and current assets.

The fixed and current assets must therefore be classified under headings appropriate to the company's business and fixed assets must be distinguished from current assets. The method or methods used to arrive at the amount of the fixed assets under each heading must be stated; this requirement does not of course mean that it is necessary to disclose cost or valuation and aggregate depreciation.

(3) Paragraph 8 (1) (d). It is thus not necessary to show separately bank loans and overdrafts.

(4) Paragraph 11 (8). It is thus not necessary to disclose the aggregate market value of the company's quoted investments other than trade investments.

(5) Paragraph 12 (1) (a) to (g); sub-paragraphs (2), (3), and (6) of paragraph 14. It is therefore not necessary to state in the profit and loss account or by way of note thereto:

- (i) Interest on debentures and fixed loans.
- (ii) The charge for United Kingdom income-tax and other United Kingdom taxation on profits.
- (iii) The basis on which the charge for United Kingdom income-tax is computed. (It is to be noted, however, that banking and discount companies but not assurance companies are subject to the requirement to disclose in the balance sheet, or by way of note, or in an annexed statement or report, the basis on which the amount set aside for United Kingdom income-tax is computed.)
- (iv) Investment income.
- (v) Amounts provided for redemption of share capital and loans.
- (vi) Any material respects in which any items shown in the profit and loss account are affected (a) by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature, or (b) by any change in the basis of accounting.

In addition to the foregoing, assurance companies (but *not* banking or discount companies) are also exempt from the requirements of the following paragraphs of the Eighth Schedule, to the extent specified:

(1) Sub-paragraphs (1) (a) and (3) of paragraph 8. Assurance companies are therefore not required to show in the balance sheet the separate amounts of the various classes of investments.

(2) Sub-paragraphs (4), (5), and (6) of paragraph 11. An assurance company is therefore not required to state:

- (i) Particulars of any charge on the assets of the company to secure the liabilities of any other person.

- (ii) Particulars of contingent liabilities.
- (iii) Capital commitments.

(3) Sub-paragraph (7) of paragraph 11. Assurance companies are therefore not required to include in the balance sheet (or in an annexed statement or report) a statement of the fact (should such be the case) that in the opinion of the directors the realisable value of certain current assets is below the amount at which they are stated.

(4) Sub-paragraph (10) of paragraph 11. Assurance companies are therefore exempt from the requirement to state the basis on which the amount set aside for United Kingdom income-tax is computed.

If the business of an assurance company includes to a substantial extent business other than assurance business the Board of Trade may direct that the company shall comply with all the requirements of the Eighth Schedule relating to the balance sheet and profit and loss account or such of them as may be specified in the direction and shall comply therewith as respects either the whole of its business or such part thereof as may be so specified.

If an assurance company is entitled to exemption from those requirements of the Eighth Schedule which have been mentioned in the foregoing, any wholly-owned subsidiary of such a company is entitled to the same exemption, provided the business of the subsidiary consists only of business which is complementary to assurance business of the classes carried on by the assurance company. For this purpose a company is deemed to be the wholly owned subsidiary of an assurance company if it has no members except the assurance company and the assurance company's wholly owned subsidiaries and its or their nominees.

A banking, discount, or assurance company which takes advantage of any of the exemptions to which it is entitled is not thereby guilty of a breach of the obligation imposed by Section 149 that the balance sheet and profit and loss account shall give a true and fair view.

EXEMPTIONS IN THE NATIONAL INTEREST. By paragraph 25 (3) of the Eighth Schedule, the Board of Trade may prescribe that a class of companies may be exempt from certain of the requirements of the Eighth Schedule, if it appears to the Board of Trade desirable in the national interest.

By paragraph 25 (1) the requirements exemption from which may be granted are:

(1) Those contained in paragraphs 4 (except so far as it relates to fixed and current assets), 6, 7, and sub-paragraph (1) (e) and (f) of paragraph 12.

The requirements are those relating to reserves, provisions and liabilities, and movements in reserves and liability provisions, which were mentioned above in connection with banking, discount and assurance companies.

(2) Those contained in paragraph 5 and sub-paragraph (1) (a) of paragraph 12, relating to the method of arriving at the amount of any fixed asset and to the disclosure of cost or valuation and depreciation.

A company taking advantage of paragraph 25 is subject to any

prescribed conditions as respects matters to be stated in its accounts or by way of note thereto and as respects information to be furnished to the Board of Trade or a person authorised by them to require it.

It is to be noted that exemption under paragraph 25 may be granted to a *class* of companies and not to individual companies. If, however, the Board of Trade are satisfied that any of the prescribed conditions has not been complied with in the case of any company, they may direct that so long as the direction continues in force the exemption shall not apply to that company.

Shipping companies have been made a prescribed class of company by the Companies (Shipping Companies Exemption) Order, 1948. For the purposes of paragraph 25, a shipping company is a company in respect of which the Board of Trade are satisfied that the greater part of its undertaking consists either directly or through a subsidiary of the ownership, management or operation of ships, other than ships employed wholly or mainly on voyages between ports in the United Kingdom, Eire, the Channel Islands and the Isle of Man.

The conditions prescribed are:

(1) In every balance sheet of the company there shall be included the following note:

'By the Companies (Shipping Companies Exemption) Order, 1948, the company is exempt from disclosing certain information relating to reserves and provisions and changes therein and certain details of fixed assets and the depreciation thereof, and these accounts have been prepared accordingly.'

(2) If, in respect of any period for which accounts of the company are made up—

- (a) any sum is transferred to the profit and loss account from a reserve or from a provision (being an amount not required for the purpose for which the provision was set aside), or
- (b) the amount stated for the company's profit or loss has been arrived at after setting aside an amount (if material) to reserves or provisions, other than provisions for depreciation, renewals, or diminution in value of assets, or
- (c) the aggregate amount of dividends paid or proposed to be paid for the period exceeds the profits for that period including any amount carried forward from the profit and loss account of the preceding period but excluding any sum to which sub-paragraph (a) of this paragraph relates

these facts shall be clearly indicated in the accounts by way of note or otherwise, and unless the amount of the sum referred to in sub-paragraph (a) of this paragraph is disclosed in the accounts, a statement in writing showing that amount shall be sent to the Board and the Ministry of Transport for their confidential information as soon as practicable after the date of the annual general meeting at which such accounts are laid before the company and not later than the date of the annual return relating to that period.

(3) Where in any balance sheet of the company capital reserves, revenue reserves or provisions (other than provisions for depreciation, renewals or diminution in value of assets) are not stated separately, any heading under which is set out an amount arrived at after taking

into account such a reserve or provision shall be so framed or marked as to indicate that fact.

(4) The profit and loss account shall indicate whether the amount stated for the company's profit or loss has been arrived at before or after providing for depreciation, renewals or diminution in value of fixed assets.

(5) The company, if so required by notice in writing from the Board, shall furnish to the Board or to an officer appointed by the Board such information with regard to its accounts as the Board may require.

PRESENTATION AND CIRCULATION OF ACCOUNTS. By Section 148, a profit and loss account (or, in the case of a company not trading for profit, an income and expenditure account) is to be laid before the company in general meeting, not later than eighteen months after the incorporation of the company and subsequently once at least in every calendar year. It is to be made up to a date not earlier than the date of the meeting by more than nine months, or, in the case of a company carrying on business or having interests abroad, by more than twelve months. The three periods mentioned may be extended by the Board of Trade, if for any special reason they think fit to do so. A balance sheet as at the date to which the profit and loss account or the income and expenditure account, as the case may be, is made up must also be laid before the company in general meeting once at least in every calendar year.

By Section 155, the balance sheet must be signed on behalf of the Board by two of the directors or by the sole director. In the case of a banking company registered after 15th August, 1879, the balance sheet must be signed by the secretary or manager, if any, and where there are more than three directors of the company, by at least three of their number, and, where there are not more than three directors, by all the directors. Section 155 emphasises the principle that the primary responsibility for the balance sheet rests on the board of directors. The auditor has no technical power to *require* the submission of the accounts in any particular form. If, however, the accounts fail to comply with any of the requirements of the Act, the remedy of the auditor lies in the terms of his report and it is his duty to use that remedy in the interests of the members of the company without reference to the desires or requests which the directors may convey to him.

By Section 156, the profit and loss account must be *annexed* to the balance sheet; in the case of holding companies, any group accounts laid before the company in general meeting must also be annexed to the balance sheet. The board of directors must approve the annexed profit and loss account (and group accounts, if any), before the balance sheet is signed on their behalf. By the same section, the auditors' report must be *attached* to the balance sheet.

By Section 157, the directors' report must be *attached* to the balance sheet. The directors' report must deal with the state of the company's affairs, the amount, if any, which they recommend should be paid by way of dividend and the amount, if any, which they propose to

carry to reserves within the meaning of the Eighth Schedule. The report must also deal, so far as it is material for the appreciation of the state of the company's affairs by its members and will not in the directors' opinion be harmful to the business of the company or of any of its subsidiaries, with any change during the financial year in the nature of the company's business, or in the company's subsidiaries, or in the class of business in which the company has an interest. It has already been pointed out above that by Section 163, any information which is required by the Act to be given in accounts, and is thereby allowed to be given in a statement annexed, may be given in the directors report, in which event the report must be *annexed* to the accounts.

By Section 158, a copy of every balance sheet, including every document required by law to be annexed thereto, which is to be laid before a company in general meeting, together with a copy of the auditors' report, must, not less than twenty-one days before the date of the meeting, be sent to the following persons: (a) every member of the company (whether he is or is not entitled to receive notices of general meetings of the company); (b) every holder of debentures of the company (whether he is or is not so entitled), and (c) all persons other than members or holders of debentures of the company, being persons who are entitled to receive notices of general meetings. It has been suggested that a copy of a company's accounts must be sent to a mortgagee of assets of the company. In the memorandum submitted by the Institute to the Board of Trade, dated 6th July, 1949, it is suggested that the definition of 'debenture' as applied to Section 158, should be narrowed, so that the requirement to send accounts should be confined to members and debenture-holders, or, alternatively, that accounts need only be sent on demand.

The documents required by law to be annexed to the balance sheet are:

- (1) The profit and loss account.
- (2) In the case of a holding company, group accounts laid before the company in general meeting.
- (3) Any document annexed to the balance sheet or profit and loss account giving information which is required by the Act to be given in accounts and is allowed by the Act to be given in that manner. If any such information is given in the directors' report, the report must be annexed to the accounts. If, however, no such information is contained in the directors' report there appears to be no obligation to circulate the directors' report. In the memorandum submitted to the Board of Trade by the Institute, dated 6th July, 1949, it is suggested that Section 158 should be amended so as to require the directors' report to be circulated with the accounts.

It may be observed here that Section 158 refers to the balance sheet and documents required to be annexed thereto; the section does not specifically mention 'accounts' or 'profit and loss account', or documents annexed thereto. Nevertheless, the profit and loss account and any annexed documents containing information

required by the Act fall within Section 158 and must be sent to all persons entitled to receive the balance sheet. This follows from the provision of Section 156 (1), by which the profit and loss account must be annexed to the balance sheet, and from the provision of Section 149 (7), by which 'any reference to a balance sheet and profit and loss account shall include any notes thereon or documents annexed thereto giving information which is required by this Act and is thereby allowed to be so given'. It is clear from this provision that any notes on, or documents annexed to, the profit and loss account, giving information required by the Act, must be regarded as part of the profit and loss account, which must itself be annexed to the balance sheet.

The obligation to send a copy of the balance sheet and annexed documents to persons of the specified classes is subject to the following exceptions.

- (1) It is not necessary to send a copy to any member of the company or any holder of debentures of the company, who is not entitled to receive notices of general meetings of the company and of whose address the company is unaware.
- (2) In the case of joint holders of any shares or debentures none of whom is entitled to receive notices of general meetings, it is sufficient to send a copy to one of the joint holders. If some of the joint holders are entitled to receive notices of general meetings and some are not so entitled, it is sufficient to send copies to those who are entitled to receive notices.
- (3) In the case of a company not having a share capital, it is not necessary to send a copy to a member or to a holder of debentures who is not entitled to receive notices of general meetings.

Any member of a company, whether he is or is not entitled to have sent him copies of the company's balance sheets, and any holder of debentures of the company, whether he is or is not so entitled, is entitled to be furnished on demand without charge with a copy of the last balance sheet of the company, including every document required by law to be annexed thereto, together with a copy of the auditors' report.

If copies of the balance sheet and annexed documents are sent less than twenty-one days before the date of the meeting, they shall, notwithstanding that fact, be deemed to have been duly sent if it is so agreed by all the members entitled to attend and vote at the meeting.

By Section 127, every company, other than an exempt private company, must annex to the annual return a written copy, certified both by a director and the secretary of the company to be a true copy, of every balance sheet laid before the company in general meeting during the period to which the return relates, including every document required by law to be annexed to the balance sheet. The auditors' report and the directors' report must also be annexed to the annual return. If the balance sheet or any document required to be annexed is in a foreign language, a certified English translation must be annexed. Section 127 does not apply to assurance companies which file their

accounts under the Assurance Companies Act, 1909, Section 7 (4). Although the section refers to a 'written copy', it is the practice of the Registrar to accept prints, provided they are signed in original by the auditors.

UNREGISTERED AND OVERSEAS COMPANIES. By Section 435 (1), the requirements of the Act relating to prospectuses, allotments, annual return, accounts and audit, may be applied, at the discretion of the Board of Trade, to unregistered companies incorporated in and having a principal place of business in Great Britain. The application is subject to such adaptations and modifications as may be specified by regulations made by the Board of Trade. The requirements which may be so applied and the limitations to which the application is subject are specified in the Fourteenth Schedule to the Act. By subsection (2) of Section 435, the specified requirements may not be applied by virtue of that Section to the following:

- (a) Any body incorporated by or registered under any public general Act of Parliament.
- (b) Any body not formed for the purpose of carrying on a business which has for its object the acquisition of gain by the body or by the individual members thereof.
- (c) Any body for the time being exempted by direction of the Board of Trade.

The provisions of Section 435 (1) have been put into general operation by the Companies (Unregistered Companies) Regulations, 1948, dated 25th June, 1948.

Overseas companies, incorporated outside Great Britain and having a place of business within Great Britain, are required, by Section 410, to prepare accounts in every calendar year and to deliver copies to the registrar of companies. The accounts must be such as are required from a company within the meaning of the Act. The Board of Trade has power to prescribe exceptions and the section does not apply to certain private companies registered under the law for the time being in force in Northern Ireland.

REDUCTION OF CAPITAL. Where the capital of a company is reduced, the Court may, by Section 68, make an order directing that the company shall for a period add to its name the words 'and reduced'. As these words are part of the name of the company, attention must accordingly be given to the heading of the balance sheet in the relative cases.

EXEMPT PRIVATE COMPANIES. By Section 28 (1) of the Act, a private company is one which, by its articles

- (a) restricts the right to transfer its shares; and
- (b) limits the number of its members to fifty, not including persons who are in the employment of the company and persons who, having been formerly in the employment of the company, were, while in that employment, and have continued after the determination of that employment to be members of the company; and

- (c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

Private companies which comply with certain conditions are known as exempt private companies and have certain important privileges. They are exempt from:

- (1) The obligation to annex to the annual return copies of the balance sheet (including annexed documents), the auditors' report and the directors' report.
- (2) The prohibition of loans to directors.
- (3) Certain of the requirements of Section 161, which provides that certain persons shall be disqualified for appointment as auditor. It is not necessary for the auditor of an exempt private company to be a member of a recognised body of accountants or individually authorised by the Board of Trade, and a person who is a partner of or in the employment of an officer or servant of the company is not disqualified from appointment as auditor of an exempt private company.

The definition of an exempt private company is contained in Section 129.

The conditions for exemption, which are set out in Section 129 and in the Seventh Schedule, are:

- (1) That the number of persons holding debentures of the company does not exceed fifty.
- (2) That no body corporate is a director of the company, and that neither the company nor any of its directors is party or privy to any arrangement whereby the policy of the company is capable of being determined by persons other than the directors, members and debenture-holders.
- (3) That no body corporate is the holder of any of the shares or debentures.
- (4) That no person other than the holder has any interest in any of the shares or debentures.

Conditions (1) and (2) are set out in Section 129 and conditions (3) and (4) are set out in paragraph 1 of the Seventh Schedule, where they are described as the basic conditions. The basic conditions are subject to a number of exceptions and modifications which are set out in the Seventh Schedule. They include the following:

- (a) If any share or debenture is subject to a charge in favour of a banking or finance company by way of security for the purposes of a transaction entered into in the ordinary course of business, the interest of such a company is to be disregarded. If the banking or finance company or its nominee is the holder of the shares or debentures, the person entitled to the equity of redemption is to be treated as the holder.
- (b) Any interest under a contract for the transfer of shares or debentures is to be disregarded until execution of an instrument of transfer, unless such execution is unreasonably delayed. On execution of the transfer the transferee is to be treated as the holder, notwithstanding that the transfer requires registration with the company, unless registration is refused.

- (c) Any interest of the company itself in any of its shares or debentures and any lien or charge arising by operation of law and affecting any of the shares or debentures are to be disregarded.
- (d) If a person entitled to shares or debentures is of unsound mind or otherwise under any disability, and by reason thereof the shares or debentures are vested in an administrator, curator or other person on behalf of the person entitled, then the person in whom any share or debenture is so vested and the person entitled thereto are to be treated, for the purposes of the Seventh Schedule, as if they were the same person.
- (e) Both the basic conditions are subject to exception for—
 - (i) Shares or debentures forming part of the estate of a deceased holder, so long as administration of his estate has not been completed.
 - (ii) Shares or debentures held by trustees on the trusts of a will or a family settlement disposing of the shares or debentures, or on trusts arising on an intestacy, so long as no body corporate has any immediate interest under the trusts; the stipulation does not apply to a body corporate established for charitable purposes only and having no right to exercise or control the exercise of any part of the voting power at any general meeting of the company or to a body corporate which is a trustee and has such an interest only by way of remuneration for acting as trustee.
 - (iii) Shares or debentures held by trustees for the purposes of a scheme maintained for the benefit of employees of the company, including any director holding a salaried employment or office in the company.
 - (iv) Shares or debentures forming part of the assets in a bankruptcy or liquidation of a holder thereof or held on trusts created for the benefit of his creditors or held for the purposes of a composition made or approved by the Court.
- (f) Condition (3) is subject to exception for shares or debentures held by a banking or finance company or by a nominee of such company where the shares or debentures were acquired in the ordinary course of business. This exception does not apply where the banking or finance company has the right (or, if two or more such companies are concerned, where they have between them the right) to exercise or control the exercise of one-fifth or more of the total voting power of the company whose shares or debentures are so held. If shares or debentures are so held by a nominee for a banking or finance company, condition (4) does not apply to the banking or finance company itself.

A subsidiary company will usually be exempt if the holding company is itself an exempt private company. This matter will be considered in Chapter IX.

OBJECT OF REVENUE ACCOUNTS. Treating first the account which in different undertakings is variously called the trading account, the manufacturing account, the working account, the profit and loss account, and the revenue account, the first point to be considered is the real object of preparing such an account. This may be stated to be the ascertainment and disclosure of:

First, the amount of business done in each of the various branches in which business is carried on.

Secondly, the amount of expenditure in each of the branches, or departments, necessary for the carrying on of that business; and

Thirdly, the amount of surplus, or profit—or loss, as the case may be—which arises from the carrying on of the business.

The object of the information is doubtless primarily to ascertain the amount of ultimate profit or loss, but beyond this there is also the further object—which, perhaps, is only fully appreciated by those skilled in accounts—of comparing the corresponding items of different periods, with a view to ascertaining how income may be increased and expenditure reduced, or, on the other hand (so far as possible), *why* income has become reduced, and *why* expenditure has increased.

An object which is secondary only in the historical sense is the focusing of figures to enable cost to be allocated to each unit of production. In most cases there is necessarily a difference of form between 'financial' and 'cost' accounts but it is one of the modern canons of good accounting that the financial accounts shall be so drafted as to facilitate the preparation and verification of the relative cost accounts.

It will thus be seen that the efficiency of the revenue account depends very materially upon the skill with which the income and expenditure have been distributed over the various headings employed, and consequently it becomes necessary to discuss the nature of the various headings under which the items of this account should be divided.

It goes without saying that, inasmuch as this account details the summarised result of the transactions recorded in the books, its exact nature will depend very materially on the precise business which is being carried on. It therefore becomes necessary further to consider the subject under the headings of various classes of business.

COMMERCIAL ACCOUNTS.—Taking first commercial concerns, it will be found that the transactions consist in the buying of goods and selling thereof, either in the precise form in which they were purchased (as in the case of traders), or in an altered form (as in the case of manufacturers); in both cases there being the further expenditure incidental to the carrying on of the undertaking.

ACCOUNTS OF TRADERS.—Dealing first with the accounts of traders, which are naturally of a simpler nature than those which require to be kept by manufacturers, the first circumstance to note is the method usually in vogue by which a trader computes the amount

of advance upon purchase price which it is necessary for him to charge for his goods in order to obtain a remunerative return for his risk and labour, this excess being very generally known as 'gross profit'. It would be very difficult to find an exact definition of the term 'gross profit', inasmuch as the items from which it is calculated will be found to vary in different undertakings; but seeing that the whole business of a trader is based upon the calculation of a fixed percentage of gross profit upon each different class of goods dealt with, it necessarily follows that any form of accounts that does not recognise the existence of such a thing as 'gross profit' fails to afford the trader that assistance which he is entitled to look for from his accounts, and consequently to a very great extent fails to justify its existence.

In general gross profit is the excess of sale price over the cost of bringing goods to the place of sale in a condition ready for sale but it has been argued by many experienced accountants that gross profit cannot be considered to arise until such things as rent of warehouse, salaries of warehousemen, &c., have been debited to the trading account; yet, as it is the almost universal custom of traders to reckon their percentage of gross profit entirely from the cost price of their *goods* (although, as a matter of convenience, they actually make the calculation backwards from their selling price) it would seem that, however correct it may be in theory, it is in practice nothing more than pedantic to include in this first section of the account anything more than sales and the closing stock on the credit side, and purchases, and the opening stock on the debit. It is, of course, quite possible to argue that the resultant credit balance means nothing; but, even if this were so, the fact remains that unless the account be so prepared it is impossible to see whether the aggregate transactions of a period actually result in the percentage of gross profit which the trader had been calculating upon throughout that period; and, therefore, whether it is thought best to call the balance of this first section 'gross profit', or to employ the indefinite term 'balance', the overwhelming weight of advantage lies in bringing the account—in this respect at least—into accord with the custom of every trader, and so enabling him to ascertain whether during any stated period he has actually achieved the results which he anticipated.

In the United States it is common practice to present revenue accounts by the 'deductive' method, i.e. to begin with the sales and to deduct therefrom the cost of sales consisting of the cost of *goods* consumed plus wages, thus arriving at the gross profit from which can be deducted the various classes of expenses, or to which can be added sundry trading receipts. This form of account has become increasingly popular in this country during recent years, and has been adopted by a number of concerns.

In the second section of the revenue account may be included all normal items of income and expenditure relating to the trading operations of the business. These expenses should be grouped in convenient subsections, so that the effect of each group upon the whole may readily be perceived. The main groupings are:

(a) selling and distribution expenses;

- (b) administration expenses; and
- (c) financial expenses.

This is useful both for the purpose of seeing how far the net profits of a concern have been affected by purely financial circumstances and how far by commercial matters.

MANUFACTURERS' ACCOUNTS. Passing on to the accounts of manufacturers, it is first necessary to subdivide this heading in accordance with the various classes of business falling thereunder. There is first of all the class of manufacturers but slightly removed from the trader—that is to say, the manufacturer who does not need to sink a large proportion of his capital in expensive plant and machinery, the most typical examples of which class are, perhaps, that of the small manufacturing jeweller and the small manufacturing tailor. In this class, as with traders pure and simple, the selling price is based on a percentage of so-called 'gross profit', the outlay in this case being the cost of materials together with the wages spent on manufacturing; and therefore, although the method may be indefensible from a theoretical point of view, the division between the first and second sections may conveniently be drawn exactly where it is drawn by the manufacturer himself in his mental calculations. Those who wish to have their accounts as complete as possible may prefer in addition to make a further subdivision of this account in the second section, separating the expenses of manufacturing (such as rent of factory, wages paid for supervision of workers, depreciation of plant, &c.) from those expenses which relate more particularly to the storing of goods and the selling thereof; but inasmuch as the only object of this break is to display separately expenses which have a different 'costing' significance there is no reason for carrying down a balance, and it is enough merely to show separate totals for these classes of expenditure in the same section.

The manufacturers belonging to the next class are those whose transactions consist in the manufacture of one or more classes of goods involving expensive plant, which goods are first manufactured and then warehoused before being sold. These undertakings are naturally upon a much larger scale than those which have just been considered, and consequently it will be found that the accounts are, as a rule, more scientifically kept, and the methods of costing more complete.

The first section of the account thus becomes divided into two parts, upon what may be called parallel lines, viz.:

The manufacturing account, which deals with the conversion of raw materials into manufactured articles, and shows the profit on manufacture and the stock of raw materials on hand.

The trading account proper, drawn up on the same lines as the first section of a trader's revenue account.

The second section of the account does not present any new features calling for consideration.

The expenses included in the manufacturing account will (as a rule) be those which are dealt with in the production cost accounts, and

those only. Factory expenses should be debited to the manufacturing account, rather than to the profit and loss account.

CONTRACTORS' ACCOUNTS. The next class of manufacturers to be dealt with consists of those who may conveniently be summarised under the head of 'contractors', i.e. those manufacturers who make articles which have already been sold for an agreed price. To this class belong builders and many engineers.

It is perhaps more in this class than anywhere else that the absolute necessity of proper cost accounts is so evident. Indeed, all contractors' accounts may be regarded as incomplete which do not provide, in addition to an ordinary profit and loss account, a 'summary of costs account', showing the same final result. This being done, the chief interest centres round the costs account rather than the profit and loss account itself, and there is thus no necessity for the latter to be unduly elaborate.

PROFIT FOR THE YEAR. If the profit and loss account is to give a clear picture of the results of the period, it should be divided into sections, so that the profit for the year can be distinguished from other debits and credits which should not be taken into account in measuring that profit. Adjustments in respect of previous years and any balance brought forward from the previous account should be set out in a later section following that in which the profit of the year is shown. If the profit for the year is affected to a material extent by profits and losses of an exceptional or non-recurrent nature, a further subdivision of the account will enable the exceptional or non-recurrent items to be segregated in a separate section. It is desirable to prepare the account so that the profit before charging taxation may be clearly distinguished from the profit remaining after charging taxation. There can be no rigid rules as to the number of sections into which the profit and loss account should be divided. Opinions on this matter differ, and there is considerable diversity in practice. There is, however, general agreement that the amount available for appropriation should be carried down to an appropriation section in which will be shown dividends and transfers to and from reserves. The presentation of a true and fair view requires that a clear and sharp distinction should be made between charges against profit and appropriations of profit. It may here be observed that depreciation and directors' fees are charges which must be borne in arriving at the profit for the year, and they should not be shown in the appropriation section.

FUTURE INCOME TAX AND INITIAL ALLOWANCES. The practice of setting up a reserve for income-tax on current profits reflects the view that it is fair and reasonable to deduct from the profit of the year the income-tax that will be based on that profit. The accepted principle is that the charge for income-tax should be in fair proportion to the amount of the profit. The application of this principle has been complicated by the fact that the incidence of initial and annual allowances for taxation purposes bears no relation to any reasonable method

of allocating depreciation charges. The initial allowance for machinery and plant is now* 40 per cent. of cost, and thus, if the annual allowance is taken into account, more than half the cost of new plant may be allowed, for taxation purposes, in a single year, with the consequence that annual allowances for subsequent years may be less than the depreciation charged in the accounts of those years.

Where the initial and annual allowances exceed the depreciation charged in the accounts the income-tax that will be based on the profit of the year is less than proportionate to the amount of the profit. The distortion may be corrected if the profit and loss account is debited with (1) the reserve for the tax that will actually become payable in respect of the profit of the current year, and with (2) an additional amount equal to tax on the excess of the initial and annual allowances over the depreciation charged in the accounts.

Some companies have shown this additional amount in the balance sheet as an 'Income-tax Equalisation account', which is a very suitable description. In any subsequent years, when the income-tax on the current profit is more than proportionate to the amount of the profit (the annual allowance being less than the charge for depreciation in the accounts) an appropriate part of the equalisation account may be transferred to the credit of profit and loss account.

In some cases, the additional amount has been treated as an additional provision for depreciation or as a reserve for replacement of fixed assets. This treatment appears to be very arbitrary, and does not reflect the fact that the immediate benefit of high initial allowances is obtained at the cost of a correspondingly heavier burden of taxation in the future.

SINGLE AND DOUBLE ACCOUNT SYSTEMS. In undertakings whose accounts are based on the latter system it is assumed that the capital of the undertaking has been sunk in the purchase and construction of definite permanent works, and the balance sheet is divided into two portions, one showing, on the one hand, the expenditure on such works, and on the other the capital raised wherewith to meet such expenditure, while the second section, or 'general balance sheet', contains what may be conveniently called the 'current' assets and liabilities arising incidentally in the course of carrying on the undertaking. It has been thought by some that this method of stating the accounts absolved the company from making any provision to meet depreciation of its permanent assets, and to a certain extent (e.g. with regard to preliminary expenses) this would appear to have been the intention of the legislature; but it is, perhaps, well to call attention to the fact that it is not only possible but also perfectly easy for provision for depreciation to be made and stated in accounts kept on the double account system. In point of fact provision *must* be made for the depreciation of wasting assets, by reason of the fact that an inherent principle of the system is the keeping up of the undertaking at the expense of revenue. The only open question is *when* the provision shall be made.

* December, 1950.

The simple truth seems to be that the double and single account systems represent two different conceptions of the 'accountability' of the directors of a concern in respect of their stewardship of the capital subscribed by members. Under double account the historical idea seems dominant; historical in the sense that the published capital account is conceived as a record of past events. Accordingly, the account consists of a report, on the one hand, of the moneys raised in pursuance of powers (usually) given by Parliament and, on the other, of the use made of those powers in acquiring fixed assets by the expenditure of the moneys raised. The present value of the assets so acquired, whether effective or intrinsic, is not deemed to be brought into question. The effective value is taken care of by the requirement that all renewals shall be met out of revenue, backed by the certificate of technical officials that the undertaking has, in fact, been kept up. The intrinsic value is irrelevant because, these undertakings being nearly always public utilities, no question of cessation of the undertaking, followed by realisation of the assets, can arise. Hence, the double account system tells the shareholder what has been done with his money, without purporting to be accurate on the quite different question what remains to be shown as a representation of the expenditure.

On the other hand the single account system lays contrasted emphasis on the present state of facts. Its balance sheet is framed so as to show the shareholder what remains to represent his money, so that he may judge whether his capital is intact. An immediate winding-up is not in contemplation, but the conception of ultimate winding-up, when the purposes of the undertaking shall have been achieved, is not absent as an abstract contingency. The single account balance sheet, consequently, does attempt what double account does not, namely, to assign present 'values' (of a kind) to the assets acquired by the expenditure of capital.

It follows that in practice the double account system is confined to undertakings which are (a) permanent and (b) of such a nature that the legislature is in a position effectively to supervise the actual keeping up of the assets. It will be seen that public utilities satisfy both these conditions and, consequently, the double account system is practically confined to undertakings in this class.

Since the nationalisation of many public utilities, the double account system is of less practical importance than in the past.

NECESSITY FOR DEPRECIATION. With regard to those few classes of undertakings whose accounts the law requires to be kept on the double account system, it would appear that (in view of the permanence of the undertaking and the consequent remoteness of realisation and the *ascertainment* of a loss) the legislature does not require any provision to be made to meet such depreciation (except in certain cases where leaseholds must be written down); but it requires all expenditure on maintenance and renewals to be borne by revenue, and it indirectly sanctions (where it does not expressly enforce) making provision to meet any outlay that may in future be

required to keep the property in a state of working efficiency equal to that in which it at first stood. On the other hand, with regard to those undertakings that are not specially provided for by the legislature, it is essential that provision should be made for depreciation.

The question of depreciation is, however, rather one of correct accounting than of legal compulsion; the matter is considered further in Chapter X in connection with the distribution of dividends.

METHOD OF PROVIDING FOR DEPRECIATION. Under the double account system, it being undesirable to obscure the record of the original cost shown in the capital expenditure account, the method adopted is to accumulate the amount set aside from time to time in a depreciation (fund) account, or a repairs and renewals fund, which is included on the left-hand side of the general balance sheet. Under the Companies Act, 1948, the amount at which a fixed asset is shown in the balance sheet must be its cost or valuation less the aggregate amount provided or written off for depreciation. It is necessary to show both cost (or valuation) and aggregate depreciation, and the figures can be more readily ascertained if depreciation is credited to a separate account rather than to the asset account.

FORM AND CONTENT OF BALANCE SHEET. The content of the balance sheet of a limited company is to a very great extent determined by the requirements of the Companies Act, 1948. The form of the balance sheet is in no small measure influenced by those requirements, since the grouping and arrangement of the various items is naturally and conveniently based on the system of classification prescribed by the Act. It is sufficient at this point, therefore, to summarise the principal groupings and to refer to certain matters which, because they do not fall within the scope of the Act, have not yet been considered. Matters relating to holding and subsidiary companies will be considered in the next chapter.

It was, until quite recently, usual to head the left-hand and right-hand sides of the balance sheet respectively 'liabilities' and 'assets'. This practice has now been abandoned by most companies, in accordance with the Recommendations on Accounting Principles, in which it is remarked that 'the use of general headings for a balance sheet, such as "liabilities" and "assets", is inappropriate and unnecessary'. The practice of using the prefixes 'to' and 'by' in the balance sheet has also been abandoned.

The items in a balance sheet fall into three main groups:

- (1) Capital and reserves;
- (2) Liabilities;
- (3) Assets.

The main groups are subdivided as follows:

- (1) Capital and reserves:
 - (a) share capital;
 - (b) capital reserves;
 - (c) revenue reserves.

- (2) Liabilities:
 - (a) long-term liabilities;
 - (b) current liabilities.
- (3) Assets:
 - (a) fixed assets;
 - (b) current assets.

Provisions for liabilities will usually represent current liabilities and the heading usually adopted is 'Current liabilities and provisions'. There may, however, be cases in which provisions will represent long-term liabilities.

There may also, as suggested earlier in this chapter, be items on both sides of the balance sheet which cannot be suitably included under any of the main headings. Subject to compliance with the requirements of the Companies Act, such items are most suitably stated separately, apart from the principal groupings.

Within each of the main groups, the items must be specified in sufficient detail to give a true and fair view of the position of the undertaking. It will not be forgotten that the Companies Act requires the separate statement of a number of specific individual items.

The share capital and capital and revenue reserves should be grouped together, and, in accordance with the Recommendations on Accounting Principles, a sub-total of share capital and reserves should be given to indicate the members' interest in the company. It is desirable that the number and value of each class of shares issued and the amount called up thereon should be given; calls in arrear may be shown as a deduction. From these details it can be seen whether any of the share capital is uncalled; if some of the shares are not fully called, this is a fact of importance, and its disclosure is clearly essential to the presentation of a true and fair view. A debit balance on profit and loss account is most suitably shown as a deduction from share capital rather than as a separate item on the right-hand side of the balance sheet, where its presence is inappropriate and misleading. A further point in connection with the description of reserves may be mentioned here; it is suggested in the Recommendations on Accounting Principles that 'the term "reserve fund" should only be used where a reserve is specifically represented by readily realisable and earmarked assets'.

The group long-term liabilities should include debentures and mortgages. The rate of interest and the date and terms of redemption should be stated. Where debentures have been issued as security for a debt, the amount of such debt should be stated as the liability, with a full note of the security held. It was at one time a common practice to show unpaid interest on debentures and mortgages as an addition to the principal moneys, on the ground that the security covers both principal and interest. It is now regarded as more suitable to include accrued interest among current liabilities, as the interest, unlike the principal, will fall due for payment at an early date. (See Recommendations on Accounting Principles, paragraph 74.)

In many trades it is customary and, indeed, essential, that merchants and manufacturers should ensure the even continuity of their business

by undertaking in advance to buy at stated periods given quantities of goods for delivery at the times and places agreed. It must be clearly understood that we are not here dealing with purchases of goods, but with contracts to make purchases. Obviously, if goods are bought in the sense that the property therein passes at once, the balance sheet is affected by the incurring of a liability and by the acquisition of the relative goods. In the case of a true forward purchase, however, the property in the goods does not at once pass; indeed, the goods may never be acquired because the intending purchaser may, before the specified moment arrives, transfer his rights and obligations to a third party. The importance of this matter was well illustrated in the notorious *Pepper Pool* case, reported in 1936, at 80 *Acct. L.R.* 33 as *Rex v. Bishirgian and others*, and reproduced in Appendix B.

In that case three persons were associated in a very ambitious scheme to 'corner' the market in pepper with the object of so forcing up the price through the artificial scarcity created as to realise a large profit in unloading the stock. The parties, however, made a grave miscalculation in overlooking the possibility that substitutes for true pepper would come forward as soon as the demand became sufficiently intense and the consequence was they had to buy quantities very greatly in excess of their original expectations. They thereupon set about to relieve their financial embarrassment by issuing a prospectus inviting share subscriptions to the old-established business of James & Shakespeare Ltd., a company controlled by them, which company was heavily involved in the forward commitments above described. No mention of the commitments was made in the published prospectus. The cash received in respect of the shares offered was used to finance the obligations arising under the general scheme.

On subsequent prosecution the party chiefly concerned was found guilty of issuing a prospectus knowing it to be false in a material particular and his two associates were also found guilty of aiding and abetting this. It is noted that the falsity consisted not in the making of statements but in the suppression of the truth. It is true that this prosecution related to the publication of a prospectus but it is generally agreed amongst accountants that the same considerations would apply to the publication of a balance sheet.

It is recommended by the Institute of Chartered Accountants that 'where goods have been purchased forward and are not covered by forward sales, provision should be made for the excess, if any, of the purchase price over the market value and should be shown as such in the accounts'. (Recommendations on Accounting Principles, paragraph 132.) It is also recommended that 'where goods have been sold forward and are not covered by stocks and forward purchases, provision should be made for the excess, if any, of the anticipated cost over sales value'. (Recommendations on Accounting Principles, paragraph 133.)

Paragraph 4 of the Eighth Schedule to the Companies Act, 1948, requires that, *inter alia*, fixed and current assets shall be classified under headings appropriate to the company's business. Paragraph 8 also requires the separate disclosure of goodwill, patents and trade-marks (as one amount), the various classes of investments and loans

for the purchase of or subscription to its own or its holding company's shares. In the Recommendations on Accounting Principles, it is suggested that the following items should be shown under separate headings:

- (i) freehold land and buildings;
- (ii) leaseholds;
- (iii) plant, machinery and equipment;
- (iv) stock-in-trade and work in progress;
- (v) trade and other debtors, prepayments and bills receivable;
- (vi) tax reserve certificates;
- (vii) bank balances and cash.

It is also recommended that debts of material amount not due until after the lapse of one year from the date of the balance sheet should be separately grouped and suitably described. In regard to tax reserve certificates, it is recommended that the accrued interest to the date of the balance sheet should not be taken to credit unless the certificates have been surrendered before the balance sheet has been signed.

If any assets are being acquired on hire purchase terms, there should be a clear intimation that an absolute title has not been acquired.

The traditional form of presenting the balance sheet as a document in which debit balances are arranged on one side and credit balances on the other is open to the objection that it is not adapted to the most logical and informative arrangement of the items. The alternative tabular form has many advocates and has been adopted by a number of companies.

By the tabular method of presentation, the current liabilities are shown as a deduction from the current assets, and the excess (if any) representing net current assets (or working capital) is thus brought into relief. Details of both current assets and liabilities may be shown in an inner column. The total of the fixed assets, with details inset, is added to the amount of the net current assets, and long-term liabilities are deducted. The resulting figure is the amount of the net assets. Immediately below this there is given a summary of the share capital and reserves, the total of which is equal to and represents the amount of the net assets.

The tabular form, in which the items are arranged in the above manner, presents a very much clearer picture than the conventional two-sided form of balance sheet. In the tabular form significant figures are thrown into clear relief and the vital distinction between reserves and liabilities is drawn more sharply and effectively than is possible under the traditional method of presentation.

Whichever form of presentation is adopted, it is desirable that the balance sheet should not be overloaded with excessive detail. The aim of those responsible for the preparation of a balance sheet should be to present a broad clear picture the significance of which can be readily appreciated.

Details and fuller information about the various items can be given in supporting notes and schedules.

CHAPTER IX

HOLDING AND SUBSIDIARY COMPANIES

INTRODUCTION. The acquisition by one company of the whole or part of the share capital of another is a method of effecting a combination of business interests which is often more convenient and suitable than a complete amalgamation. It is possible to obtain control of a company without acquiring the whole of its share capital and an effective unification of policy and direction may be achieved in circumstances in which a complete amalgamation would not be practicable. There has been a progressive growth in the number of holding and subsidiary companies during recent years, and the existence of groups of interconnected companies has become an important and prominent feature of the economic and business structure. The contrast between unity of policy and direction within a group of companies and the existence of a number of separate legal entities has led in some cases to abuses. In the words of the report of the Cohen Committee on Company Law Amendment, the system has, from the shareholders' point of view, 'been accompanied in a large number of cases by an absence of information as to the financial position and results of the undertaking in which they are interested'. Under the provisions of the Companies Act, 1929, it was necessary to disclose, in the balance sheet of the holding company, the aggregate of shares in subsidiary companies, the aggregate indebtedness of subsidiaries to the holding company and the aggregate indebtedness of the holding company to its subsidiaries. No disclosure of the liabilities, reserves and assets of the subsidiaries was required. The Act of 1929 provided that there should be annexed to the balance sheet of a holding company a statement indicating:

- (1) how the profits and losses of subsidiaries had been dealt with in the accounts of the holding company; and
- (2) to what extent (a) provision had been made for the losses of a subsidiary company either in the accounts of that company or of the holding company or both, and (b) losses of a subsidiary company have been taken into account by the directors of the holding company in arriving at the profits and losses of the holding company as disclosed in its accounts.

It was not, however, necessary to specify the actual amount of the profits or losses of any subsidiary company, or the actual amount of any part of any such profits or losses which had been dealt with in any particular manner. The shareholders of a holding company might therefore be kept in ignorance of the results of the operations of the subsidiaries.

Many holding companies published more information than the law required, but it was felt that full disclosure of the position and results of subsidiary companies should be made compulsory. The Recom-

recommendations on Accounting Principles advocated disclosure, and recommended the submission of a consolidated balance sheet and a consolidated profit and loss account as being the most suitable method, in most cases, of disclosing the information.

The Cohen Committee on Company Law Amendment accepted this view, and the general principles on which the committee's recommendations regarding holding and subsidiary companies are based are set out in paragraph 117 of the report:

'We consider that the accounting information published by the holding company to supplement the balance sheet which, as a separate legal entity, it publishes, should as far as is reasonably practicable include information with regard to the financial position and results of the group similar to that which would be required by statute if the business were carried on by a single company operating through a number of branches.'

The committee were of the opinion that

'the issue with the holding company's accounts of a consolidated balance sheet and a consolidated profit and loss account combining the figures of the holding company with those of its subsidiaries is the best means of showing the financial position and results of the group as a whole.'

The committee recognised, however, that

'exceptional cases may arise where the consolidation of accounts in whole or in part may be impracticable or misleading. The accounts of some subsidiaries may not be available because, for example, they are working in a country torn by civil war; if a subsidiary is hopelessly insolvent and the holding company, being under no liability to meet its debts, is not willing to do so; or if the assets of a subsidiary consist largely of balances in a foreign currency which owing to exchange restrictions cannot be transferred, it may be impracticable or misleading to include its liabilities and assets and results in consolidated accounts.'

The definition of a subsidiary company in the Act of 1929 was unsatisfactory. It was so worded as to exclude sub-subsidiaries; companies which were subsidiaries of subsidiary companies were not themselves subsidiaries of the main holding company. On the other hand, in the words of the report (paragraph 118):

'by its reference to a holding of a majority of the share capital the definition includes as subsidiaries companies which may be neither under the holding company's *de facto* control for management purposes as branches of the business of the holding company group nor subject to its legal power of control as regards such matters as the appointment of a majority of their directors. A company may, for example, own the whole of a second company's preference capital which, though it carried no voting rights and has no rights to participate in profits beyond its fixed dividends, is greater in amount than the ordinary share capital to which the whole of the voting power and the whole of the equity in surplus profits are attached. Under the present definition the second company is deemed to be a subsidiary of the first even if it is not in fact in any way controlled by the first. . . . In our view the question of control should as a general rule be decisive and we consider that the only case where absence of legal power to control need not exclude a company from the status of a subsidiary company should be where the holding company owns more than one-half of the equity, since such a concentrated holding may well give practical control of the business although the holding company does not necessarily possess a majority of the voting power.'

The views expressed in the report are amplified in a series of recommendations designed to secure full disclosure of the financial position and results of holding and subsidiary companies.

The requirements of the Companies Act, 1948, must now be considered.

REQUIREMENTS OF THE COMPANIES ACT, 1948, IN REGARD TO HOLDING AND SUBSIDIARY COMPANIES

DEFINITIONS:

(a) *Subsidiary*. By Section 154 (1), a company shall be deemed to be a subsidiary of another if:

- (1) that other company is a member of it *and* controls the composition of its board of directors; or
- (2) that other company holds more than half in nominal value of its equity share capital; or
- (3) the first mentioned company is a subsidiary of any company which is that other's subsidiary.

It will be seen that if *any one* of the above three conditions is fulfilled, the company in question is a subsidiary of the other company.

In (1) above, the emphasis is upon control.

By Section 154 (2), the composition of a company's board of directors shall be deemed to be controlled by another company only if that other company by the exercise of some power exercisable by it without the consent or concurrence of any other person can appoint or remove the holders of all or a majority of the directorships. The second company is, however, deemed to have the power of appointing to a directorship of the first company if a person cannot be appointed thereto without the exercise in his favour by the second company of a power which does not require the consent or concurrence of any other person. The second company is also deemed to have the necessary power of appointment if a person's appointment as director of the first company follows necessarily from his appointment as director of the second company or the directorship is held by the second company or its subsidiary.

As to (2) above, by Section 154 (5), 'equity share capital' means the issued share capital excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution.

By (3) above, the definition of subsidiary is extended to include a sub-subsidiary, i.e. a company which is a subsidiary of a subsidiary of the holding company. The definition covers a subsidiary of a sub-subsidiary and so on *ad infinitum*. It is also provided by Section 154 (3) that, in determining whether one company is a subsidiary of another, any shares held or power exercisable by a subsidiary of that other shall be treated as held by that other. Thus, if two fellow-sub-subsidiaries of the same holding company each hold 30 per cent. in nominal value of the equity share capital of a third company, the holding company is treated, by virtue of Section 154 (3), as holding 60 per cent. in nominal value of the equity share capital of the third company, and the third company is therefore a subsidiary of the holding company.

To prevent evasion of the requirements of the Act by the device of appointing nominees to hold shares or empowering nominees to control the composition of a board of directors, it is provided, under Section 154 (3), that, in determining whether one company is a sub-

subsidiary of another any shares held or power exercisable by any person as a nominee for that other or as a nominee of a subsidiary of that other, shall be treated as held or exercisable by that other.

Any shares held or power exercisable by a company or by its subsidiary in a fiduciary capacity are to be disregarded for purposes of Section 154. Similarly, shares held or power exercisable by a nominee of a company or its subsidiary are to be disregarded if the company or its subsidiary, as the case may be, is concerned only in a fiduciary capacity. It is also provided, by subsection (3) (c) and (d) of Section 154 that, in determining whether one company is a subsidiary of another, (1) any shares held or power exercisable by any person by virtue of the provisions of any debentures of the first-mentioned company or of a trust deed for securing any issue of such debentures shall be disregarded; and (2) any shares held or power exercisable by, or by a nominee for, that other or its subsidiary (other than by virtue of the provisions of any debentures or trust deed as mentioned in the foregoing) shall be treated as not held or exercisable by that other if the ordinary business of that other or its subsidiary, as the case may be, includes the lending of money and the shares are held or the power is exercisable by way of security only for the purposes of a transaction entered into in the ordinary course of that business.

It may be noted at this point that, for the purposes of Section 196 (which deals with disclosure in the accounts of directors' emoluments, &c.), but for no other purpose, the definition of subsidiary is further extended. Section 196 (9) provides that if a person is or was, while a director of a company, a director also, by virtue of the company's nomination, direct or indirect, of any other body corporate, that body corporate shall be deemed, for purposes of Section 196, to be the company's subsidiary, whether or not it is or was so in fact.

(b) *Holding Company.* By Section 154 (4), a company shall be deemed to be another's holding company if, but only if, that other is its subsidiary.

OBLIGATION TO PRESENT GROUP ACCOUNTS. By Section 150 (1) of the Act, where at the end of its financial year a company has subsidiaries, 'group accounts' shall be laid before the company in general meeting when the company's own balance sheet and profit and loss account are so laid.

Group accounts are accounts dealing with the state of affairs and profit and loss of the holding company and its subsidiaries.

The group accounts must be presented at a general meeting of the holding company.

As will be shown below, the obligation is subject to certain exceptions.

The group accounts are not a substitute for the normal profit and loss accounts and balance sheets of the companies which are members of the group. The directors of the holding company and every subsidiary respectively remain under the obligation to present at the general meeting of each separate company its own separate profit and loss

account and balance sheet. This generalisation is, however, subject to the exception that the holding company's profit and loss account may be framed as a consolidated profit and loss account. There is no such exception in the case of subsidiary companies, and the separate profit and loss account and balance sheet of each subsidiary must be presented at that company's general meeting.

Group accounts are normally to take the form of a consolidated profit and loss account and balance sheet, but the Act provides that group accounts may take other forms. The financial year of each subsidiary company must normally coincide with the financial year of the holding company. If, however, there are good reasons to the contrary, the financial year of a subsidiary may differ from that of the holding company, provided the reasons for the difference and certain particulars regarding dates are given with the group accounts. The form and content of group accounts are considered more fully at a later stage in this chapter.

EXCEPTIONS TO OBLIGATION TO PRESENT GROUP ACCOUNTS. The report of the Cohen Committee on Company Law Amendment recognised that cases may arise where the consolidation of accounts in whole or in part may be impracticable or misleading. It is also true that there may be good reasons for excluding certain subsidiaries from the group accounts whatever form the group accounts may take.

By Section 150 (2) (a), group accounts are not required in the case of a holding company which is itself the wholly owned subsidiary of another body corporate incorporated in Great Britain. By Section 150 (4), a body corporate is deemed to be the wholly owned subsidiary of another if it has no members except that other and that other's wholly owned subsidiaries and its or their nominees. The minimum number of members for a private company is two; by Section 31 of the Act, if the number of members falls below the legal minimum, and the company carried on business for more than six months while the number is so reduced, every member of the company who is cognisant of the fact is severally liable for the whole of the company's debts. This difficulty can be overcome, in the case of a wholly-owned subsidiary, if the subsidiary has at least one member (other than the holding company) who is a nominee of the holding company. It would obviously be superfluous to require the production of group accounts in the case of a wholly-owned subsidiary company which has subsidiaries of its own, since the sub-subsidiaries are themselves deemed to be subsidiaries of the main holding company. The group accounts of the main holding company will deal with all members of the whole group, including the sub-subsidiaries, and will therefore incorporate all the matter that would be included in group accounts dealing with the wholly-owned subsidiary and its subsidiary companies.

The exception under Section 150 (2) (a) is therefore merely intended to avoid unnecessary multiplication of accounts, and is thus only technically an exception to the main requirement of the section.

It is provided by Section 150 (2) (b) that group accounts need not

deal with a subsidiary if the directors of the holding company are of the opinion that:

- (1) it is impracticable; or
- (2) it would be of no real value to members of the holding company, in view of the insignificant amounts involved; or
- (3) would involve expense or delay out of proportion to the value to the members of the holding company; or
- (4) the result would be misleading; or
- (5) the result would be harmful to the business of the holding company or any of its subsidiaries; or
- (6) the business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking.

If the directors of the holding company are of such an opinion about each of the company's subsidiaries, group accounts are not required.

A subsidiary may not be excluded from the group accounts on the grounds mentioned in either (5) or (6) above without the approval of the Board of Trade. The approval of the Board of Trade is not required if the exclusion is on any of the grounds specified in (1) to (4) inclusive above.

In the opinion of counsel, the responsibility for giving the opinion that group accounts need not deal with a particular subsidiary is that of the directors of the holding company alone. If the directors make statements of fact which are inconsistent with the accounts, the auditors should refer to this in their report. If, however, the reasons given are matters of opinion, or matters of fact which are consistent with the accounts on which the auditors are reporting, the auditors, in the opinion of counsel, owe no duty to the shareholders to make any comment on the directors' reasons. (I.C.A., paragraph 154.)

STATEMENT REQUIRED WHERE GROUP ACCOUNTS ARE NOT SUBMITTED OR IN RELATION TO ANY SUBSIDIARY EXCLUDED FROM THE GROUP ACCOUNTS.

(1) *Application of Requirement.* It must not be supposed, if no group accounts are submitted, that the directors of the holding company are relieved from all obligation to give information to the shareholders with regard to the subsidiaries. Neither must it be supposed that, if any subsidiary is excluded from the group accounts, the shareholders of the holding company are entitled to no information about that subsidiary.

It is provided by paragraph 15 (4) of the Eighth Schedule that, where group accounts are not submitted, there shall be annexed to the balance sheet of the holding company a statement showing the reasons why subsidiaries are not dealt with in group accounts, and giving certain information about the subsidiaries, in particular with regard to their profits and losses.

A similar statement is required in regard to any subsidiary excluded from the group accounts and, if the group accounts consist wholly or partly of consolidated accounts, in regard to any subsidiary not dealt with by the consolidated accounts. By paragraph 21 of the Eighth Schedule, there shall be annexed to the consolidated balance sheet the like statement, in regard to any subsidiaries not dealt with by the consolidated accounts, as is required by paragraph 15 (4) where there are no group accounts. By Section 152 (3) of the Act, the group accounts if not prepared as consolidated accounts, shall give the same or equivalent information. Taking Section 152 (3) in conjunction with paragraph 21 of the Eighth Schedule, it is clear that a statement giving the information required by paragraph 15 (4) must be given in regard to any subsidiary excluded from the group accounts, whatever form the group accounts may take.

The Board of Trade may, on the application or with the consent of the holding company's directors, direct that in relation to any subsidiary the requirements of paragraph 15 (4) shall not apply or shall apply only to such extent as may be provided by the direction.

It is a curious fact that a holding company which is itself the wholly-owned subsidiary of another body corporate incorporated in Great Britain although exempt as noted above, under Section 150 (2) (a), from the obligation to present group accounts, is not exempt from the obligation to annex to its balance sheet the statement required by paragraph 15 (4) of the Eighth Schedule. Answering a question put to them on this point, counsel expressed the opinion that the required particulars must be given in every case where group accounts are not submitted, whatever the reason for not submitting group accounts. (I.C.A., paragraph 157.) Since the purpose of exempting such a company from the obligation to present group accounts is to avoid unnecessary duplication, it seems odd that there is no corresponding exemption from the requirements of paragraph 15 (4). It seems probable that the omission of such exemption was unintentional.

(2) *Matters to be shown in the statement.* The matters to be shown in the statement required by paragraph 15 (4) are the following:

- (1) The reasons why subsidiaries are not dealt with in group accounts. If group accounts are submitted and any subsidiary is not dealt with therein, the reasons for the exclusion must be given. (Paragraph 15 (4) (a).)
- (2) Information regarding profits and losses of subsidiaries, or of any subsidiaries excluded from the group accounts, as the case may be. (Paragraph 15 (4) (b) and (c).)
- (3) Any qualifications contained in the report of the auditors of the subsidiaries, or of any subsidiaries excluded from the group accounts, as the case may be. It is also necessary to state any note or saving contained in the accounts of such subsidiaries to call attention to a matter which would otherwise properly have been referred to in a qualification in the auditors' report. These requirements, however, apply only in so far as the matter

which is the subject of the qualification or note is not covered by the holding company's own accounts and is material from the point of view of its members. (Paragraph 15 (4) (d).)

(3) *Information regarding profits and losses of subsidiaries.* The statement required under paragraph 15 (4) must show:

- (1) The net aggregate amount of the revenue profits less losses (or vice versa) of the subsidiary or subsidiaries to which the statement applies, excluding profits and losses attributable to outside shareholders and pre-acquisition profits and losses, not dealt with in the accounts of the holding company.
- (2) The net aggregate amount of the revenue profits less losses (or vice versa) of the subsidiary or subsidiaries to which the statement applies, excluding pre-acquisition profits and losses, dealt with in the holding company's accounts.

In the case of (1) it is necessary to distinguish between profits and losses for the respective financial years of the subsidiaries ending with or during the financial year of the holding company, and those for their previous financial years since they respectively became the holding company's subsidiaries. In the case of (2), it is necessary to distinguish between profits and losses for the respective financial years of the subsidiaries ending with or during the financial year of the holding company and those for their other financial years since they respectively became the holding company's subsidiaries.

The distinction between 'previous financial years' in relation to profits and losses not dealt with in the holding company's accounts and 'other financial years' in relation to profits and losses dealt with in the holding company's accounts is an interesting one. The point here is that in an exceptional case a subsidiary company whose financial year does not coincide with that of the holding company may, during a particular financial year of the holding company, pay an interim dividend in respect of its own financial year ending *after* the financial year of the holding company during which the latter receives the dividend. In the normal case, of course, the distinction is between current profits and losses and past profits and losses.

Thus four separate aggregates must be given, but it is not necessary to distinguish between the profits and losses of individual subsidiaries.

It seems clear that the intention of the provisions of paragraph 15 (4) (b) and (c) is that the following amounts should be disclosed:

- (i) Relevant profits and losses of subsidiaries for the current year dealt with in the accounts of the holding company for the current year.
- (ii) Relevant profits and losses of subsidiaries for the current year not dealt with in the accounts of the holding company for the current year.
- (iii) Relevant profits and losses of subsidiaries for previous years dealt with in the accounts of the holding company for the current year.

- (iv) Relevant profits and losses of subsidiaries for previous years not dealt with in the accounts of the holding company for the current or any previous year.

In the opinion of counsel, however, the desired result has not been achieved. In their opinion, the references to the 'company's accounts' in paragraph 15 (4) (b) and (c) mean the holding company's accounts for the year in question, and do not include accounts for previous years. (I.C.A., paragraphs 160 and 161.)

It follows that any revenue profits of the subsidiaries for previous years which were distributed to the holding company in previous years and which were dealt with in the accounts of the holding company for previous years cannot be regarded, for purposes of paragraph 15 (4), as having been 'dealt with, in the company's accounts'. In consequence the statement must include profits of subsidiaries for previous years which were distributed to the holding company in previous years as part of the aggregate profits not dealt with in the holding company's accounts. The words of paragraph 15 (4) (b) of the Eighth Schedule 'have, therefore, the presumably unintended effect of calling for the disclosure of useless figures of profits less losses of subsidiaries for the whole period from their acquisition less only amounts dealt with in the holding company's accounts of the year and not after deducting amounts dealt with in earlier accounts of the holding company.' (I.C.A., paragraph 159.)

Counsel cite the case (I.C.A., paragraph 163) of two wholly-owned subsidiaries acquired on 1st January, 1947, making a net aggregate profit of £15,000 in each of the years 1947, 1948, and 1949, distributing £5,000 in each year between them and retaining as a revenue reserve £10,000 in each year. In the opinion of counsel, the statement annexed to the holding company's accounts for 1949 would be: 'The net aggregate amount of the subsidiaries' profits for the year 1949 was £15,000, of which £5,000 is dealt with in these accounts and £10,000 is not so dealt with. The net aggregate amount of the subsidiaries' profits for their previous financial years since they became subsidiaries is £30,000, no part of which is dealt with in these accounts.' Counsel point out (I.C.A., paragraph 164) that this is unsatisfactory in that the shareholders are not informed that, of the £30,000 profits made by the subsidiaries in previous years, £20,000 is still retained by them while £10,000 has been paid to the holding company by way of dividends.

It is stated (I.C.A., paragraph 165) that the Council of the Institute 'has been in communication with the Board of Trade and is authorised to state that no exception will be taken by the Board of Trade to the information required under the paragraph in question being dealt with by companies on the lines indicated in paragraph 158 above'. That is to say, no exception will be taken to a statement which omits the profits of subsidiaries which were distributed as dividends in previous years and so included in the accounts of the holding company for previous years. It is suggested (I.C.A., paragraph 165) that the form of statement suggested by counsel in paragraph 163 (quoted above) would be amended to read as follows:

	<i>Profits in respect of financial years of subsidiaries</i>		
	<i>Ending in 1949</i>	<i>Other years</i>	<i>Total</i>
	£	£	£
The net aggregate amount of the profits less losses (A) of the subsidiaries so far as it concerns the members of this company (B):			
(i) dealt with in this company's accounts for the year 1949 amounted (gross) to	9,090		9,090
Less income-tax	4,090		4,090
	£5,000	(C)	£5,000
(ii) not dealt with in this company's accounts for the year 1949 amounted, after charging taxation, to	£10,000	£20,000	£30,000

(A) Where applicable.

(B) Where one or more than one subsidiary is not wholly owned.

(C) 'Other years' will normally be years of subsidiaries ending prior to the holding company's year 1949; but if an interim dividend were declared by a subsidiary out of its profits for a year ending within the holding company's year 1950, and taken up in the holding company's accounts for 1949, the amount of such interim dividend would be included in this column.

In the memorandum submitted to the Board of Trade by the Council of the Institute, dated 6th July, 1949, it is suggested that paragraph 15 of the Eighth Schedule requires amendment so as to give effect to the apparent intention of the Act, as expressed in paragraph 158 of the Institute's booklet.

Pre-acquisition profits and losses. The statement required by paragraph 15 (4) is to show only 'profits and losses of a subsidiary which may properly be treated in the holding company's accounts as revenue profits or losses'. (Paragraph 15 (5), Eighth Schedule.)

Profits earned by a subsidiary company before the holding company acquired the shares, although they may be revenue profits from the standpoint of the subsidiary as a separate entity, are not revenue profits from the standpoint of the holding company. This important principle is recognised in paragraph 123 of the report of the Cohen Committee on Company Law Amendment in the following words:

'Profits earned and losses incurred by subsidiary companies before the acquisition by the holding company of the shares to which they are attributable are, as a matter of accounting practice, viewed as being of a capital nature from the standpoint of the holding company. Such pre-acquisition results (whether dealt with in the accounts of the holding company or not) have, therefore, been regarded as not capable of being brought into account as profits or losses in determining the profits which the holding company might properly regard as available for distribution in dividend by itself.'

On general principles, therefore, it is clear that the statement required by paragraph 15 (4) should not include such pre-acquisition profits or losses. The matter is placed beyond doubt by paragraph 15 (5) which explicitly provides that

'the profits or losses attributable to any shares in a subsidiary for the time being held by the holding company or any other of its subsidiaries shall not . . . be treated [in the holding company's accounts as revenue profits or losses] so far as they are profits or losses for the period before the date on or as from which the shares were acquired by the [holding] company or any of its subsidiaries.'

It is made clear by paragraph 15 (5) that if a holding company transfers shares in one subsidiary to a second subsidiary (the first subsidiary thus becoming a sub-subsidiary) any profits or losses of the first subsidiary attributable to such shares for the period before the transfer are to be treated as revenue profits and losses, in so far, of course, as they are profits or losses for a period after the shares were first acquired by the holding company. This applies also to a transfer of shares in a sub-subsidiary by one subsidiary to another. The pre-acquisition profits or losses of any company which must be treated as being of a capital nature are therefore those earned or incurred before the shares to which they are attributable were acquired by any member of the group.

If a holding company acquires shares in a subsidiary during the course of an accounting year of the subsidiary, it is necessary to decide how much of the subsidiary's profits or losses for that accounting year relates to the pre-acquisition period. It is provided by paragraph 15 (5) that

'For the purpose of determining whether any profits or losses are to be treated as profits or losses for the said period [i.e. the pre-acquisition period] the profit or loss for any financial year of the subsidiary may, if it is not practicable to apportion it with reasonable accuracy by reference to the facts, be treated as accruing from day to day during that year and be apportioned accordingly.'

The shares in a subsidiary which are acquired by a holding company are not necessarily or always acquired *en bloc* on a single date. A controlling interest may be acquired gradually or by stages. A company may acquire certain shares in another company without acquiring a controlling interest and may then at a later date acquire additional shares sufficient to give it control of the second company and to make the second company its subsidiary for purposes of the Companies Act. It seems reasonable in such a case, if the first purchase is of substantial amount, to make an apportionment of the second company's profits and losses as at the date of the first purchase of shares, and to treat such part of the second company's profits or losses as are attributable to those shares, for the period after purchase, as revenue profits and losses from the purchasing company's standpoint. There does not appear to be any good reason for regarding the profits or losses of the second company arising during the interval between the first and second purchase of shares, so far as they are attributable to the shares purchased on the earlier date, as being of a capital nature. The fact that, during the period in question, the relationship of holding and subsidiary company had not been established scarcely justifies the view that all the profits of the subsidiary remaining undistributed at the date of purchase should be regarded as being of a capital nature from the standpoint of the holding company. A different view may, however, be taken if the earlier purchase of shares is of a comparatively small amount.

Interest of outside or minority shareholders. By paragraph 15 (4) (b) of the Eighth Schedule, the statement of profits and losses of subsidiaries not dealt with in the accounts of the holding company must show the net aggregate amount of those profits and losses 'so far as it

concerns members of the holding company'. That is to say, profits and losses attributable to shares in subsidiaries which are not held by the holding company are not required to be stated.

Furthermore, by paragraph 15 (5), the requirement applies 'only to profits and losses of a subsidiary which may properly be treated in the holding company's accounts as revenue profits and losses'. It need hardly be said that profits and losses attributable to shares held by minority or outside shareholders cannot properly be treated in a holding company's accounts as revenue profits and losses.

(4) *Statement if required information is not obtainable.* It is provided by paragraph 15 (4) that, in so far as the required information is not obtainable, there must be annexed to the balance sheet of the holding company a statement that it is not obtainable.

FORM AND CONTENT OF GROUP ACCOUNTS

(1) *A true and fair view.* By Section 152 (1), 'the group accounts laid before a [holding] company shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole, so far as concerns members of the company'.

The qualifying phrase 'so far as concerns members of the holding company' is significant. Group accounts in the normal form of consolidated accounts are of little value to either creditors or outside shareholders of the subsidiary companies. A holding company may be under no obligation to meet the debts of an insolvent subsidiary. The interests of the outside shareholders of a subsidiary are confined to the particular member of the group the shares of which they hold.

(2) *Financial year of holding company and subsidiaries.* By Section 153 (1), the directors of a holding company must secure that the financial year of each of its subsidiaries shall coincide with the holding company's own financial year.

This requirement is, however, subject to the qualification 'except where in their opinion there are good reasons against it'. The qualification reflects the view of the Committee on Company Law Amendment. The report (paragraph 120) remarks that 'owing to the considerable diversity of businesses frequently carried on by members of the group it would not, in our view, be practicable to insist upon a common date; for example, where the business of a subsidiary company is seasonal, it is a matter of practical business convenience that the accounts of such subsidiary should be made up at a date when the results of the season's operations can be most suitably ascertained'. In the opinion of counsel, the responsibility for giving the opinion that there are good reasons against the financial year of any of the subsidiaries of a holding company coinciding with the holding company's own financial year is that of the directors of the holding company alone. (I.C.A., paragraph 154.)

If the financial year of a holding company and a subsidiary do not coincide and there are no good reasons why they should not, it may be necessary to extend the financial year of either the holding company

or the subsidiary so as to make the subsidiary's financial year end with that of the holding company. This might involve, as regards the company concerned, a breach of the requirements of the Act in relation to the annual general meeting and annual return. To overcome this difficulty, Section 153 (2) provides as follows:

'Where it appears to the Board of Trade desirable for a holding company or a holding company's subsidiary to extend its financial year so that the subsidiary's financial year may end with that of the holding company, and for that purpose to postpone the submission of the relevant accounts to a general meeting from one calendar year to the next, the Board may on the application or with the consent of the directors of the company whose financial year is to be extended direct that, in the case of that company, the submission of accounts to a general meeting, the holding of an annual general meeting or the making of an annual return shall not be required in the earlier of the said calendar years.'

As regards cases where the financial years of holding and subsidiary company do not coincide, it is provided by Section 152 (2) as follows:

'Where the financial year of a subsidiary does not coincide with that of the holding company, the group accounts shall, unless the Board of Trade on the application or with the consent of the holding company's directors otherwise direct, deal with the subsidiary's state of affairs as at the end of its financial year ending with or last before that of the holding company, and with the subsidiary's profit or loss for that financial year.'

In the ordinary case where the financial years do not coincide, the group accounts will relate, as far as the subsidiary is concerned, to its financial year ending within the financial year of the holding company. Where, however, the financial year of a holding company or a subsidiary is extended so that the financial years of both may end on the same date, the accounting period which is extended will be a period of more than a year. It is perhaps anomalous to describe such an accounting period as a financial year or, for that matter, to speak of the extension of a financial year. The point is covered in Section 455 of the Act, in which it is provided that "'financial year" means, in relation to any body corporate, the period in respect of which any profit and loss account of the body corporate laid before it in general meeting is made up, whether that period is a year or not'. Where the financial year of either holding or subsidiary company is extended so that both may end on the same date, the financial years will not on that occasion coincide although both end on the same date. In such a case, the group accounts must, in accordance with Section 152 (2), deal with the subsidiary's state of affairs as at the end of its financial year (which may in practice be a period of more than a year) ending *with* that of the holding company, and with the subsidiary's profit or loss for that financial year.

It will have been noticed that Section 152 (2) contains the saving clauses 'unless the Board of Trade on the application or with the consent of the holding company's directors otherwise direct'. In the opinion of counsel, the subsection gives the Board of Trade power to allow the accounts of a subsidiary to deal with its state of affairs as at a date other than the end of its financial year and with its profit and loss for a period other than that of its financial year. The Board has

accordingly, in the opinion of counsel, power to allow 'special accounts' to be made up to a particular date and for a particular period. (I.C.A., paragraph 148.)

Such special accounts, as they are not the accounts of the subsidiary for its financial year, will not be the accounts laid before the subsidiary company in general meeting. Counsel have expressed the opinion that the accounts of a subsidiary dealt with in consolidated accounts need not have been formally adopted by the subsidiary in general meeting. (I.C.A., paragraph 149.)

If the financial years of any subsidiaries do not end with that of the holding company, there must be annexed to the balance sheet of the holding company a statement showing:

- (a) the reasons why the holding company's directors consider that the subsidiaries' financial years should not end with that of the holding company; and
- (b) the dates on which the subsidiaries' financial years ending last before that of the holding company respectively ended or the earliest and latest of those dates.

This statement is required, by paragraph 15 (6) of the Eighth Schedule, where group accounts are not submitted. By paragraph 22 of the Eighth Schedule, a similar statement is required in relation to any subsidiaries, whether or not dealt with by the consolidated accounts, whose financial years did not end with that of the holding company. It has been noted earlier in this chapter that, by Section 152 (3), if the group accounts are not prepared as consolidated accounts, they shall contain the same or equivalent information. A statement as above must therefore be given in every case where the financial year of a subsidiary does not end with that of the holding company.

(3) *Consolidated Accounts.* The view of the Cohen Committee on Company Law Amendment, as expressed in paragraph 119 of the report, that 'the issue with the holding company's accounts of a consolidated balance sheet and a consolidated profit and loss account combining the figures of the holding company with those of its subsidiaries is the best means of showing the financial position and results of the group as a whole'.

The principle adopted in the Act is that group accounts should normally be in the form of consolidated accounts.

By Section 151 (1),

'the group accounts laid before a holding company shall be consolidated accounts comprising (a) a consolidated balance sheet dealing with the state of affairs of the company and all the subsidiaries to be dealt with in group accounts, and (b) a consolidated profit and loss account dealing with the profit or loss of the company and those subsidiaries.'

Cases may, however, arise where consolidated accounts would be impracticable or misleading. It is accordingly provided that in certain circumstances group accounts may be prepared in a form other than that of consolidated accounts. Alternative forms of group accounts will be considered at a later stage in this chapter.

By Section 152 (3), the group accounts, if prepared as consolidated

accounts, must comply with the requirements of the Eighth Schedule, so far as applicable thereto.

The main requirements of the Eighth Schedule in relation to consolidated accounts are contained in paragraphs 17 and 18, which are as follows:

'17: Subject to the following paragraphs of this Part of this Schedule, the consolidated balance sheet and profit and loss account shall combine the information contained in the separate balance sheets and profit and loss accounts of the holding company and of the subsidiaries dealt with by the consolidated accounts, but with such adjustments (if any) as the directors of the holding company think necessary.'

'18. Subject as aforesaid and to Part III of this Schedule, the consolidated accounts shall, in giving the said information, comply, so far as is practicable, with the requirements of this Act as if they were the accounts of an actual company.'

The above requirements reflect the view of the Committee on Company Law Amendment, expressed in paragraph 117 of the report, quoted earlier in this chapter, in the following terms:

'We consider that the accounting information published by the holding company to supplement the balance sheet which, as a separate legal entity, it publishes, should as far as is reasonably practicable, include information with regard to the financial position and results of the group similar to that which would be required by statute if the business were carried on by a single company operating through a number of branches.'

The essence of subsection (3) of Section 152 and paragraphs 17 and 18 of the Eighth Schedule is that the consolidated accounts should combine the information contained in the separate accounts of the members of the group, and should comply with the requirements of the Act as if they were the accounts of a single company.

Such a requirement must inevitably be subject to certain modifications, which can conveniently be considered under four headings.

(i) *Modification by the Board of Trade.* Section 152 (3) includes the proviso that the Board of Trade may, on the application or with the consent of the company's directors, modify the said requirements (i.e. compliance with the Eighth Schedule) in relation to that company for the purpose of adapting them to the circumstances of the company.

(ii) *Special classes of company.* If any banking, discount or assurance company, or any company of a class prescribed by the Board of Trade, is entitled to exemption from any of the requirements of the Eighth Schedule, and that company is a holding company, the consolidated accounts of the group may be prepared subject to the same exemption.

(iii) *Directors' emoluments and loans to officers.* It is provided by paragraph 19 of the Eighth Schedule that Sections 196 and 197 of the Act shall not apply for the purpose of consolidated accounts.

Section 196 requires the disclosure in accounts of directors' emoluments, &c., and Section 197 requires the disclosure of loans to officers. Both these sections have been considered in Chapter VIII of this book.

It will be remembered that under Section 196 it is necessary to disclose in the accounts or in an annexed statement the aggregate of directors'

emoluments and the aggregate of directors' or past directors' pensions, including the emoluments, &c., receivable by a person for his services, while director of the holding company, as director of any subsidiary company or in connection with the management of the affairs of any subsidiary. It is also necessary to disclose the aggregate of compensation for loss of office as director of any subsidiary or in connection with the management of any subsidiary, if the loss of office occurs while the person concerned is a director of the holding company or in connection with the termination of such directorship. The amounts to be disclosed in the holding company's account include all relevant sums payable by or receivable from the company's subsidiaries. In so far, therefore, as directors of subsidiaries are directors of the holding company, their emoluments, &c., must be included in the amounts disclosed in the accounts of the holding company, and it would be superfluous to repeat the information in the consolidated accounts. It is not necessary to disclose either in the holding company's own accounts or in the consolidated accounts the emoluments, &c., of directors of subsidiary companies who are not also directors of the holding company. The emoluments, &c., of such directors must of course be included in the aggregates disclosed in the separate accounts of the subsidiary companies of which they are respectively directors, in conformity with the provisions of Section 196. From the point of view of the shareholders of the holding company, to whom the consolidated accounts are presented, a director of a subsidiary company who is not also a director of the holding company holds a position which is more analogous to that of a branch manager than a director.

If a holding company incorporates its own profit and loss account in a consolidated profit and loss account, as permitted by Section 149 (5), and presents no separate profit and loss account of its own, then the information regarding directors' emoluments required by Section 196 must be given in the consolidated profit and loss account.

(iv) '*Such adjustments as the directors of the holding company think necessary*'. The qualifying phrase 'with such adjustments (if any) as the directors of the holding company think necessary' occurs in paragraph 17 of the Eighth Schedule. It is a very necessary qualification, since, as accountants are well aware, the preparation of consolidated accounts involves more than the mere addition of the figures which appear in the separate profit and loss accounts and balance sheets of the members of the group. Paragraph 18 of the Eighth Schedule, which requires the consolidated accounts to comply with the requirements of the Act as if they were the accounts of an actual company is similarly modified by the phrase 'so far as practicable'.

Certain adjustments are necessarily made as a matter of course in the preparation of any consolidated accounts, and, in some cases, special adjustments may be found necessary by reason of lack of uniformity in accounting methods among members of the group.

The more important of the adjustments which are normally necessary include the following:

If a consolidated balance sheet is prepared as at the date on which

a holding company acquires the shares of a subsidiary company, the method of consolidation is to eliminate the cost of the shares from the balance sheet of the holding company and to substitute the assets and liabilities of the subsidiary company. The net assets (i.e. assets minus liabilities) of the subsidiary at the date of acquisition represent the share capital plus reserves of the subsidiary at that date. The share capital and reserves of the subsidiary therefore do not appear in the consolidated balance sheet, which represents the position of the holding company as it would have been if the holding company had purchased the net assets of the other company instead of its shares. The capital and reserves of a vendor do not appear in the books or balance sheet of a purchaser.

If the holding company has acquired the whole share capital of the subsidiary, and the price paid is exactly equal to the share capital and reserves of the subsidiary, no adjustment will usually be required in a consolidation at the date of acquisition other than the omission of the capital and reserves of the subsidiary. If, however, the price paid for the shares is greater than the book value of the subsidiary's net assets, then, assuming that the book value of the net assets requires no adjustment, the excess must be introduced into the consolidated balance sheet as goodwill, or, if a goodwill figure is included in the books of the subsidiary, as an addition to such goodwill. If the purchase price of the shares is less than the book value of the subsidiary's net assets and those net assets are incorporated in the consolidated balance sheet without adjustment, the deficiency must appear as a capital reserve or as a deduction from goodwill.

If the holding company has acquired a part only of the share capital of the subsidiary, the goodwill or capital reserve, as the case may be, must be calculated as the difference between the purchase price of the shares and the book value of a proportionate part of the subsidiary's net assets. If the whole of the net assets of the subsidiary are incorporated in the consolidated balance sheet, arithmetical agreement is maintained by introducing the interest of the outside or minority shareholders in the subsidiary's net assets as an item on the left-hand side.

When a consolidated balance sheet is prepared at a date subsequent to the acquisition of the shares by the holding company, the figure of goodwill or capital reserve calculated as at the date of acquisition will normally be introduced without change. The net assets of the subsidiary will, however, have increased by the amount of any profits earned since the date of acquisition, so far as such profits have not been distributed; alternatively, the net assets will have diminished by the amount of any net loss incurred by the subsidiary since the acquisition date. The post-acquisition profits (so far as not distributed) and post-acquisition losses of the subsidiary must therefore be introduced into the consolidated balance sheet. The reasons for the inclusion of a subsidiary's post-acquisition profits and losses and the exclusion of its pre-acquisition profits and losses will readily be appreciated if the subsidiary is conceived as being analogous to a branch business which has been purchased outright. It is apparent, also, that the

arithmetical agreement of the consolidated balance sheet requires the introduction of the subsidiary's post-acquisition profits and losses. If the holding company has purchased a part only of the share capital of the subsidiary, only the holding company's proportion of the subsidiary's post-acquisition profits and losses will be shown as such in the consolidated balance sheet. The proportion of the post-acquisition profits attributable to the outside or minority shareholders will be shown as an addition to the amount of their interest, and their proportion of a post-acquisition loss will be shown as a deduction.

The calculation of a subsidiary's pre-acquisition profits and losses, and hence the figure for goodwill or capital reserve to be incorporated in the consolidated balance sheet, in cases where the holding company acquires the shares of the subsidiary during the course of the subsidiary's accounting period or where the holding company acquires control gradually by a series of purchases of shares at different dates, has been considered above in connection with the statement required by paragraph 15 (4) of the Eighth Schedule.

In Chapter VIII, it was pointed out that, in the opinion of counsel, an amount set aside for future income-tax is a reserve. This anomaly creates a serious difficulty on consolidation since the amount set aside at the date of acquisition in the books of a subsidiary for future income-tax must, on this view, be regarded as pre-acquisition profit.

A consolidated balance sheet therefore differs from an aggregation of the separate balance sheets of the members of the group in that it excludes the share capital of the subsidiaries and the profits and losses of the subsidiaries earned or incurred prior to the acquisition of the shares. On the other hand, it includes as goodwill or capital reserve the amount of the difference between the purchase price of the shares and the net assets attributable to such shares, and includes also as a separate item the interest of outside or minority shareholders.

If a subsidiary incurs losses after the date of acquisition, those losses may, in the subsidiary's books, be debited against profits earned prior to that date. In the consolidated accounts, however, such losses will operate to reduce the current earnings of the group as a whole. On the other hand, a debit balance on the profit and loss account of a subsidiary as at the date of acquisition may be eliminated by profits earned after acquisition. From the point of view of the group as a whole, such post-acquisition profits should logically be regarded as revenue reserves available for distribution. In view, however, of the fact that, from the standpoint of the subsidiary as a separate entity, such profits would not normally be regarded as free for distribution without setting off the earlier loss, it may be thought more prudent to treat them in the consolidated accounts as a capital reserve. Should a subsidiary, after the acquisition of its shares by the holding company, declare and pay a dividend out of profits earned prior to acquisition, such a dividend should be treated, in the books of the holding company, as a credit to the cost of the shares. If this treatment is adopted, the matter does not create any problem on consolidation.

The calculation of goodwill, for consolidation purposes, as the excess of the purchase price of the shares over the book values of the

attributable net assets assumes that no adjustment of the book value of the subsidiary's net assets is necessary. The purchase price of the shares may, however, have been determined on the basis that the subsidiary's fixed assets are worth more or less than their book value. If this is so, it is considered proper to introduce the subsidiary's fixed assets into the consolidated balance sheet at the amount taken into account for the purpose of determining the purchase price of the shares. To the extent that the subsidiary's fixed assets are written up or written down for consolidation purposes, the amount treated as goodwill is reduced or increased, as the case may be. In such circumstances, the depreciation provided in the consolidated profit and loss account will usually be related to the amount at which the fixed assets are introduced into the consolidated balance sheet, and will therefore be greater or less than the depreciation provided in respect of those assets in the profit and loss account of the subsidiary.

There are some differences of opinion as to the manner in which the fixed assets of subsidiaries should be shown in the consolidated balance sheet. Apart from any question of revaluation by reference to the price paid for the shares, the fixed assets of the subsidiaries may, where the information is available, be shown at their original cost to the subsidiaries, with the aggregate depreciation written off or provided in the subsidiaries' books shown as a deduction. Alternatively, the fixed assets of the subsidiaries may be introduced at their net book amount at the date of acquisition, with subsequent depreciation only shown as a deduction; additions since the date of acquisition may be brought in at cost with depreciation as a deduction. If the fixed assets of any subsidiary were, at the date of acquisition, regarded as worth more than their book value and the higher value was taken into account in determining the purchase price of the shares, it may be thought suitable to show such an amount in the consolidated balance sheet as a valuation made at the date of the acquisition of the shares.

In addition to the adjustments mentioned in the foregoing, other adjustments may have to be made in the light of the circumstances of each individual case. The following may be mentioned:

- (a) Indebtedness between members of the group should be eliminated.
- (b) Shares in the holding company held by any subsidiary should be eliminated, adjusting any difference between the book value and the par value of such shares by making the necessary alteration to goodwill or capital reserve arising on consolidation.
- (c) Inter-company profits or losses should be eliminated.
- (d) Inter-company dividends should be eliminated.
- (e) Adjustments may be necessary if the members of the group have not all adopted the same basis of accounting. It is important, if the consolidated accounts are to present a true and fair view of the state of affairs and profit or loss of the group as a whole, that uniform principles and methods should be applied. Methods of treating taxation, in particular, may differ, and adjustment is frequently necessary in this respect. Overseas subsidiaries may give rise to difficult problems.

A very valuable summary of points of difficulty arising in connection with the consolidated accounts has appeared in a booklet issued by the Institute of Chartered Accountants, entitled 'Group Accounts in the Form of Consolidated Accounts; Some Notes by the Taxation and Financial Relations Committee'.

Auditors' Remuneration. Paragraph 13 of the Eighth Schedule provides that 'if the remuneration of the auditors is not fixed by the company in general meeting, the amount thereof shall be shown [in the profit and loss account] under a separate heading, and . . . any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression "remuneration"'. .

It may be that, in the case of some members of the group, the auditors' remuneration has been fixed in general meeting and in consequence is not disclosed in the accounts, while in the case of other members of the group, it has not been so fixed and is therefore shown as a separate item in the accounts. By paragraph 17 of the Eighth Schedule, a consolidated profit and loss account must combine the information contained in the separate profit and loss accounts. It has been pointed out in paragraph 32 of the Institute's booklet on the Companies Act that 'normally it would be valueless to show in the consolidated profit and loss account the aggregate of any items of auditors' remuneration shown in the separate accounts, since the aggregate would often not be the total auditors' remuneration within the group'. Nevertheless, in the opinion of counsel, the aggregate of auditors' remuneration as disclosed in the separate accounts should appear in the consolidated accounts. (See I.C.A., paragraph 33.)

Financial Years. As mentioned earlier in this chapter, there must be annexed to the consolidated balance sheet a statement containing the information required by paragraph 15 (6) of the Eighth Schedule in relation to any subsidiaries whose financial years did not end with that of the holding company. It has also been pointed out that under Section 152 (2) the Board of Trade has power to allow special accounts to be made up to a particular date and for a particular period, in the case of a subsidiary whose financial year does not end with that of the holding company. In the opinion of counsel, the accounts of a subsidiary dealt with in consolidated accounts need not have been formally adopted by the subsidiary in general meeting.

Subsidiary excluded from consolidated accounts. If any subsidiaries are not dealt with in the consolidated accounts, paragraph 21 of the Eighth Schedule requires that the consolidated accounts shall contain the same information in regard to the excluded subsidiaries as the normal accounts of a holding company would contain in regard to its subsidiaries as a whole. The reader is referred to the last part of this chapter in which the separate accounts of holding and subsidiary companies are considered.

Briefly stated, the principal effect of this requirement is that the consolidated balance sheet must show as separate items:

- (1) Aggregate of shares in the excluded subsidiaries held by other members of the group.
- (2) Aggregate of amounts owing by the excluded subsidiaries to the other members of the group.
- (3) Aggregate of amounts owing to the excluded subsidiaries by other members of the group.

Paragraph 5 of the Eighth Schedule does not apply to shares in excluded subsidiaries; if such shares have been written down, it is not necessary to disclose cost and the amount written off. Neither is it necessary to give, in regard to such shares, the information which is required in regard to other investments.

If any excluded subsidiary holds any shares or debentures of any member of the group included in the consolidation certain particulars of those shares and debentures must be given in a note on the consolidated balance sheet or in an annexed statement or report.

It is also necessary to annex to the consolidated balance sheet a statement giving, in regard to the excluded subsidiaries, the information required by paragraph 15 (4) of the Eighth Schedule where group accounts are not submitted. (Paragraph 21 (b) of the Eighth Schedule.)

(4) *Group Accounts in forms other than consolidated accounts.* The Committee on Company Law Amendment recognised that there will be cases in which consolidation of accounts is inappropriate. The following passage is taken from paragraph 120 of the report:

'The accounts of some subsidiaries may not be available because, for example, they are working in a country torn by civil war; if a subsidiary is hopelessly insolvent and the holding company, being under no liability to meet its debts, is unwilling to do so; or if the assets of a subsidiary consist largely of balances in a foreign currency which owing to exchange restrictions cannot be transferred, it may be impracticable or misleading to include its liabilities and assets and results in consolidated accounts.'

In paragraph 25 of the 'Notes on Group Accounts in the Form of Consolidated Accounts' issued by the Institute of Chartered Accountants, it is observed under the heading 'Overseas Subsidiaries' that—

'There may be subsidiaries which adopt bases of accounting different from those of the holding company, particularly in regard to the method of stating assets or computing profits and losses. It is not always practicable for the holding company to insist on appropriate changes being made where the subsidiaries are subject to company or taxation law different from that in the United Kingdom. If differences are acute and material there are three methods of dealing with the position:

- (a) To exclude such subsidiaries from the consolidation; or
- (b) To consolidate separately the subsidiaries concerned; or
- (c) To make such adjustments as may be necessary for consolidation purposes.'

Apart from the special cases mentioned in the foregoing passages, it may be that the businesses of holding and subsidiary company are so dissimilar that consolidation would be inappropriate.

Section 151, while requiring that group accounts shall be consolidated accounts dealing with the holding company and all its subsidiaries, nevertheless provides that they may be prepared in some other form.

By Section 151 (2), 'if the company's directors are of opinion that it is better or the purpose (a) of presenting the same or equivalent information about the state of affairs and profit or loss of the company and those subsidiaries, and (b)

of so presenting it that it may be readily appreciated by the company's members; the group accounts may be prepared in a form other than that required by the foregoing subsection.'

It will be seen that the choice between consolidated accounts dealing with the holding company and all the subsidiaries and some other form of group accounts is not a free and unrestricted choice. A different form may be adopted only if the directors of the holding company are of opinion that some other form is *better* for the purposes of presenting the information and of presenting the information so that it may be readily appreciated.

The choice of a form of group accounts other than that of consolidated accounts dealing with all the members of the group, even if made on legitimate grounds, does not entitle the directors to withhold information that would be disclosed by such consolidated accounts. By Section 151 (2), an alternative form may be adopted only if, in the opinion of the directors, it is better for the purpose of presenting *the same or equivalent information*. Section 152 is even more explicit; by Section 152 (3), the group accounts, if not prepared as consolidated accounts, must give the same or equivalent information.

The Companies Act does not impose any restrictions on the form of presentation that may be adopted if the group accounts are not consolidated accounts dealing with all members of the group.

The following forms, however, are specifically authorised by Section 151 (2):

- (1) More than one set of consolidated accounts dealing respectively with the holding company and one group of subsidiaries and with other groups of subsidiaries.
- (2) Separate accounts dealing with each of the subsidiaries.
- (3) Statements expanding the information about the subsidiaries in the company's own accounts.
- (4) Any combination of the above three forms.

Subsection (5) of Section 149 provides as follows:

'Subsections (1) and (2) of this section shall not apply to a company's profit and loss account if—

- (a) the company has subsidiaries; and
- (b) the profit and loss account is framed as a consolidated profit and loss account dealing with all or any of the company's subsidiaries as well as the company, and—
 - (i) complies with the requirements of this Act relating to consolidated profit and loss accounts; and
 - (ii) shows how much of the consolidated profit or loss for the financial year is dealt with in the accounts of the company.'

Subsection (1) of Section 149 provides that the profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year. By subsection (2) of Section 149, the profit and loss account of a company must comply with the requirements of the Eighth Schedule.

If the profit and loss account of a holding company is framed as a consolidated profit and loss account and no separate profit and loss account of the holding company is presented, it does not present a true and fair view of the holding company's own profit or loss for the financial year. Subsection (5) of Section 149, therefore, makes this

procedure possible by relieving a company which adopts it (subject to the specified conditions) from the obligation of presenting a true and fair view of its own profit or loss for the financial year.

There is no corresponding dispensation in regard to the balance sheet, and a holding company is not in any circumstances relieved from the obligation imposed by Section 149 (1) in regard to the balance sheet, i.e. that the balance sheet of a company shall give a true and fair view of the state of affairs of the company. A consolidated balance sheet of a group does not give a true and fair view of the state of affairs of the holding company alone and does not satisfy, in regard to the holding company, considered as a separate entity, the requirements of the Eighth Schedule.

It has been noted earlier in this chapter that, by paragraph 19 of the Eighth Schedule, Sections 196 and 197 do not apply to consolidated accounts and that in consequence particulars of directors' emoluments are not required to be given in a consolidated profit and loss account. If, however, a holding company frames its profit and loss account as a consolidated profit and loss account and presents no separate profit and loss account of its own, then the information regarding directors' emoluments, &c., required by Section 196 must, in the opinion of counsel, be given in such a consolidated profit and loss account. (See I.C.A., paragraphs 117-118.) If this were not so, the requirements of Section 196 would be ineffective in relation to such a company.

Many companies have taken advantage of the provisions of Section 149 (5). The consolidated profit and loss account gives the shareholders of the holding company the information they require as to the earnings of the group as a whole. The separate profit and loss account of a holding company is regarded as a relatively unimportant document, since the directors of the holding company can usually arrange to incorporate therein as much or as little of the profits and losses of the subsidiaries as they desire. Such an account may therefore give little indication of earnings in the true sense. Somewhat different considerations apply to the balance sheet. A holding company may be under no obligation to meet any of the liabilities of its subsidiaries, and, from the standpoint of the holding company's creditors in particular, the holding company's separate balance sheet may be of more interest than a consolidated balance sheet.

The great majority of holding companies have presented their group accounts in the form of consolidated accounts. If any other form is adopted, e.g. separate accounts dealing with each of the subsidiaries, such accounts must give the same or equivalent information as would be given in consolidated accounts. It will therefore be necessary to indicate in such accounts or by means of a note, *inter alia*, the amount of pre-acquisition profits, the division of profits between the holding company and the outside or minority shareholders, and the interest of the latter in the net assets of the subsidiary company.

Subsection (3) of Section 151 provides that the group accounts may be wholly or partly incorporated in the holding company's own balance sheet and profit and loss account. In some cases, the balance sheet of the holding company and the consolidated balance sheet have been

presented as a single document, the figures of the holding company's balance sheet and those of the consolidated balance sheet appearing side by side in parallel columns. A similar method has been applied to the holding company's own profit and loss account and the consolidated profit and loss account.

THE SEPARATE ACCOUNTS OF HOLDING AND SUBSIDIARY COMPANIES. Subject to the relaxation mentioned above, by which a holding company is permitted to frame its profit and loss account as a consolidated profit and loss account, every holding and subsidiary company must present its own separate accounts. The requirement that group accounts shall be laid before a holding company in general meeting is additional to the requirements relating to accounts which apply to all companies.

(a) *Holding companies.* The separate accounts of a holding company must comply with the requirements of the Act in regard to the balance sheet and profit and loss account.

In addition, by sub-paragraphs (2) and (3) of paragraph 15 of the Eighth Schedule, certain matters must be shown in the accounts of a holding company.

(1) The aggregate amount of shares in subsidiary companies must be stated separately in the balance sheet.

(2) The aggregate of indebtedness (whether on account of loan or otherwise) owing from subsidiary companies must be shown in the balance sheet.

Paragraph 15 does not require any distinction to be made between debentures of subsidiaries held by a holding company and other indebtedness of subsidiaries; neither does this paragraph require any separation between advances for capital purposes or other long-term loans and current indebtedness.

It must be borne in mind, however, that, by paragraph 4 (2) of the Eighth Schedule, fixed assets must be distinguished from current assets. If, therefore, any indebtedness of subsidiaries has the character of a fixed asset, it will be necessary to state it separately. It has been pointed out in paragraph 53 of the Institute's booklet on the Companies Act and again in the memorandum of 6th July, 1949, submitted by the Council of the Institute to the Board of Trade, that certain assets including, *inter alia*, advances to subsidiaries, may, by their nature, be fixed assets or current assets, or partly one and partly the other. It is also stated in paragraph 57 of the Institute's booklet on the Companies Act that no objection will be taken by the Board of Trade to an asset not being described as fixed or current if to do so would not be a true and fair description, provided the nature of the asset is stated clearly.

The principle that a balance sheet must show a true and fair view must always be a paramount consideration, and in the light of this principle, a suitable method of presentation is to show 'Interests in Subsidiaries' as a main heading in the balance sheet, showing the following under separate sub-headings:

- (a) Shares in subsidiaries.
- (b) Debentures of subsidiaries.
- (c) Advances for capital purposes and long-term loans.
- (d) Current indebtedness.

By paragraph 4 (3) of the Eighth Schedule, it is necessary to state the method or methods used to arrive at the amount of the fixed assets under each heading. It is therefore necessary to state the basis of valuation of shares in subsidiaries, of debentures in subsidiaries and of any indebtedness which is, by its nature, a fixed asset.

Paragraph 5, sub-paragraph (1) (a) of paragraph 12, and sub-paragraph (2) of paragraph 14 of the Eighth Schedule do not apply in relation to fixed assets consisting of interests in the company's subsidiaries. (Paragraph 15 (2) (b), Eighth Schedule.) If, therefore, shares in, or debentures of, subsidiaries have been written down below cost, it is not necessary to disclose either the cost or the aggregate amount written off. As regards the profit and loss account, it is not necessary to state the amount written off (if any) or to give any particulars regarding methods of providing for depreciation or replacement.

It is also provided, by paragraph 15 (2) (a) that

'the references in Part I of this Schedule to the company's investments shall not include investments in its subsidiaries required by this paragraph to be separately set out.'

It is thus not necessary to show income from investments in subsidiaries as a separate item in the profit and loss account. Neither is it necessary to distinguish in the balance sheet those investments in subsidiaries which are quoted from those which are not quoted. No particulars of the market value of investments in subsidiaries are required.

(3) By paragraph 15 (2), the aggregate amount of a holding company's indebtedness (whether on account of loan or otherwise) to its subsidiaries must be shown in the holding company's balance sheet separately from all other liabilities.

(4) If any shares in or debentures of the holding company are held by subsidiaries or their nominees, there must, by paragraph 15 (3) of the Eighth Schedule, be shown by way of a note on the balance sheet of the holding company, or in an annexed statement or report, the number, description and amount of such shares or debentures.

This requirement does not apply to any shares in or debentures of the holding company in the case of which the subsidiary is concerned as personal representative or in the case of which it is concerned as trustee and neither the holding company nor any subsidiary thereof is beneficially interested under the trust, otherwise than by way of security only for the purposes of a transaction entered into by it in the ordinary course of a business which includes the lending of money.

By Section 27 of the Act, a body corporate cannot, subject to certain exceptions, be a member of a company which is its holding company. By this section, neither a subsidiary company nor its nominee may acquire shares in the holding company, and any allotment or transfer of shares in a holding company to a subsidiary or its nominee

is void. The section does not apply to shares in a holding company which were held by a subsidiary or its nominee on 1st July, 1948, but such shares are deprived of voting rights. There is also an exception for shares in the case of which the subsidiary is concerned as personal representative or where it is concerned as trustee, provided that neither the holding company nor a subsidiary thereof is beneficially interested under the trust other than by way of security for the purposes of a transaction entered into by it in the ordinary course of a business which includes the lending of money.

(b) *Subsidiary companies.* By paragraph 16 (1) of the Eighth Schedule, it is necessary to show in the balance sheet of a subsidiary company, under separate headings:

- (1) The aggregate amount of its indebtedness to its holding company and fellow subsidiaries.
- (2) The aggregate amount of the indebtedness of its holding company and fellow subsidiaries to it.

In each case, it is necessary to distinguish between indebtedness in respect of debentures and otherwise. The expression 'fellow subsidiary' is defined by paragraph 16 (2), as follows:

'For the purposes of this paragraph, a company shall be deemed to be a fellow subsidiary of another body corporate if both are subsidiaries of the same body corporate but neither is the other's.'

If a subsidiary company holds shares in its holding company or in fellow subsidiaries, it is desirable that these should be stated separately in the balance sheet, although the Act does not specifically require it. The reader is reminded that particulars of shares in a holding company held by a subsidiary must be given in a note or statement annexed to the holding company's balance sheet. Shares in the holding company and in fellow subsidiaries will, it is thought, be classed as trade investments, of which the aggregate only is required by the Act to be shown.

The Council of the Institute has recommended that 'shares held by a subsidiary in a fellow subsidiary should normally be shown in the balance sheet of the subsidiary as a separate sub-heading, under "Trade investments" and should not be merged with other trade investments'. (I.C.A., paragraph 167.)

It must be remembered that a subsidiary company may have subsidiaries of its own, in which case it is both a holding and a subsidiary company. Such a company must comply with the requirements of paragraph 15 of the Eighth Schedule in regard to holding companies, so far as they are relevant, and similarly with the requirements of paragraph 16 in regard to subsidiary companies. Paragraph 15 (1) specifically provides that 'this paragraph shall apply where the company is a holding company, whether or not it is itself the subsidiary of another body corporate'. Similarly, paragraph 16 applies to a subsidiary company, 'whether or not it is itself a holding company'.

EXEMPT PRIVATE COMPANIES. One of the basic conditions which must be satisfied if a private company is to rank as an exempt

private company is that no body corporate is the holder of any of its shares or debentures. If a subsidiary of an exempt private company is in other respects itself qualified as an exempt private company, its status as such is not invalidated by the fact that some or all of its shares are held by a body corporate which is also exempt, i.e. the holding company. This follows from paragraph 6 of the Seventh Schedule, which provides that 'the first of the basic conditions shall be subject to an exception for shares held by another private company which is itself an exempt private company'.

Under a proviso to paragraph 6, the subsidiary will not, however, be an exempt private company if, taking all the companies concerned into account, the total number of persons holding shares in these companies is more than fifty, excluding employees and former employees and excluding such of the companies concerned as hold shares in any other company concerned. Joint shareholders are treated for purposes of this proviso as a single person.

The companies concerned, for this purpose, are:

- (a) the subsidiary;
- (b) the holding company;
- (c) any further company taken into account for the purposes of the proviso in determining the right of the holding company to be treated as an exempt private company.

Thus, if company C. is the wholly-owned subsidiary of company B., and company B. is the wholly-owned subsidiary of company A., in determining whether the subsidiary (company C.) is exempt, the companies to be taken into account are A., B., and C. Company C. will not be exempt if the total number of shareholders in the three companies exceeds fifty.

The status of holding and subsidiary companies as exempt private companies is not invalidated by the fact that the subsidiary holds shares in the holding company if they are both qualified in all other respects.

It is a curious fact that the exception under paragraph 6 of the Seventh Schedule extends only to shares held by an exempt private company and does not apply to debentures so held. A subsidiary of an exempt private company therefore cannot itself be an exempt private company if any of its debentures are held by the holding company. It has been suggested, in the memorandum submitted by the Council of the Institute to the Board of Trade, dated 6th July, 1949, that 'it seems desirable to amend paragraph 6, Seventh Schedule, to read throughout "shares or debentures" instead of "shares"'.

By Section 31 of the Act, the minimum number of members for a private company is two. In the case of a wholly-owned subsidiary, it is necessary, if the number of members is not to fall below the legal minimum, that there should be, in addition to the holding company, at least one other member who may be a nominee of the holding company. If, however, there is a nominee shareholder, there is a failure to satisfy the second basic condition, i.e. that no person other than the holder has any interest in any of the shares or debentures.

It seems that this difficulty may be overcome by the execution of

instruments of transfer of nominee holdings in favour of the holding company, withholding such transfers from registration. This view is based on sub-paragraph (4) of paragraph 2 of the Seventh Schedule, which provides that 'on execution of an instrument of transfer of a share or debenture, the transferee and not the transferor shall be treated as the holder, notwithstanding that the transfer requires registration with the company, unless registration is refused'. This rule would seem to apply to paragraph 6, since sub-paragraph (1) of paragraph 2 provides that 'the rules contained in the following sub-paragraphs of this paragraph shall apply for the purposes both of the basic conditions and of the exceptions from those conditions'. It is also thought that if shares are registered in the joint names of a nominee and the holding company, the basic conditions may be satisfied.

Nevertheless, it can only be regarded as unsatisfactory that there should be any need to resort to such devices. It is suggested in the above-mentioned memorandum of the Institute that 'it seems desirable to amend sub-paragraph (1) of paragraph 6, Seventh Schedule, to the effect that the basic conditions shall be subject to an exception for shares held by or as nominee of another private company which is itself an exempt private company'.

CHAPTER X

PROFITS AND THEIR DIVISIBILITY

IN the preceding chapters most of the points arising in the course of an audit have been considered in some detail with a view to ascertaining that all due precautions have been taken to test the accuracy of accounts before passing them; but it is advisable to review some of these various questions from the point of view of considering whether the amount of profit stated on the face of the accounts is actually available for dividend. It is most important to remember in this connection, however, that until an undertaking has actually been wound up, any statement as to the profits earned is merely an estimate or a statement of opinion, and not a question of fact.

ADVANTAGES OF DOUBLE ENTRY. The reader will hardly require to be reminded that, in the case of an ordinary undertaking, the amount of profit available for distribution will be represented on the balance sheet by the excess of the assets there disclosed over the liabilities and paid-up capital of the undertaking. But it is desirable for the auditor, in order to make sure of his position, to look at the matter not merely from a balance sheet point of view but, in the first place, to scrutinise the revenue account carefully in order to see that no sources of income have been taken credit for unduly, and that all expenses incurred in the course of earning the income have been properly debited, and then to compare the profit shown by such revenue account with the surplus stated to be available on the face of the balance sheet, after scrutinising all the assets and liabilities there disclosed. By this means he will have the advantage of looking at the matter from two points of view, which, in so difficult a question as the assessment of profits, is of the utmost value.

CAPITAL v. REVENUE. It will be seen from what has been said above that, at all events economically speaking, no profits are available for distribution until provision has been made for keeping the whole of the paid-up capital of the undertaking intact. The legal necessity for this provision has, however, been rendered somewhat doubtful by many decisions which have been given in the Courts from time to time. Foremost among these may be named the following: *Lee v. The Neuchatel Asphalte Co. Ltd.*; *Verner v. General and Commercial Investment Trust Ltd.*; *Wilmer v. McNamara & Co. Ltd.*; *Dovey v. Cory (In re The National Bank of Wales Ltd.)*; and *The Ammonia Soda Co. Ltd. v. Chamberlain*; all of which will be found reported in full in Appendix B to the present work. It may be stated, however, that the general effect of all these decisions was that *in certain circumstances it might not be necessary* for a company, before declaring a dividend out of profits alleged to have been earned, to provide in that year's accounts for the whole of the loss caused by the depreciation of

the whole or some portion of its assets. In the case *Lee v. The Neuchatel Asphalt Co. Ltd.*, it is true that the facts disclosed did not place it beyond doubt that the fixed assets of the company were in fact less valuable than when they were taken over in the first instance; but in the three later cases the fact that some depreciation had occurred was undisputed, and although some provision had been made for this depreciation in the two last-named cases, it was not seriously contended that a sufficient sum had been written off to cover the whole of the loss.

On the other hand, it is very desirable that no undue importance should be attached to these decisions, for it must be remembered that the first three arose out of a motion on the part of one or more shareholders to obtain an injunction against the directors of a company to restrain them from declaring a dividend; and that in the absence of any evidence that creditors would be defrauded, or the rights of one or more classes of shareholders seriously prejudiced, the Courts would naturally not lightly interfere with the deliberate action of the directors, endorsed by a resolution of the company passed in general meeting, in regard to a matter which certainly appears to be essentially one of internal administration. The decision in *Re The National Bank of Wales Ltd.*, arose out of a misfeasance summons, and the main question was thus whether the respondent was personally responsible for the position of affairs disclosed.

It seems clear that a distinction must be made between the case of a company which is formed with the object of acquiring and working a wasting asset and that of a company which may be expected to carry on its business for an indefinite period. In the latter case, when plant and machinery is worn out, it will in the normal course of events be replaced. It appears that to arrive at the profit available for distribution provision should, as a matter of law, be made for the depreciation of such fixed assets as must be replaced. This view is supported by the judgment in *Re Crabtree, Thomas v. Crabtree*, from which the following passage is taken:

'But in the ordinary course of ascertaining the profits of a business where there is power machinery and trade machinery which is necessary in order to perform the work of the business, it is, in my opinion, essential that in addition to all sums actually expended in repairing the machinery, or in renewing parts, that there should also be written off a proper sum for depreciation, and that sum ought to be written off before you can arrive at the net profits of the business. . . . The only authorities referred to were those of companies formed to work a wasting property, and in such a case all profit arising from the wasting property is divisible without any deduction for the depreciation in value of the wasting property. That is because the object of the company was to acquire a wasting property and to divide all the profits. That is not so here. The profits of this business are not ascertained until a sufficient sum has been deducted to meet the depreciation of the machinery.'

It must be observed that no limited company was concerned in the *Crabtree* case; the point at issue was the ascertainment of the income payable to a life tenant who was entitled, under the terms of a will, to the profits of a business.

In the case of *Edwards v. Saunton Hotel Co. Ltd.* [1943], to which reference was made in Chapter VII, a manager was entitled to a commission of 20 per cent. of the sum available for distribution by a

company at the end of each year. In the course of his judgment, Atkinson, J., said:

'Of course, there is no dispute that depreciation properly ascertained must be, and ought to be, deducted from the sum earned in order to arrive at the true profits which the company has made.'

It is interesting to note that it was held that the calculation of depreciation should be on the fixed instalment method.

Some of the most difficult questions that arise under this heading occur in the case of a company which has sold a part of its undertaking; but the general principles to be applied in such cases have been fairly well defined by the Courts. In the case *Lubbock v. British Bank of South America Ltd.*, it was decided by Chitty, J., in 1892, that so long as it was not *ultra vires* the company, a profit made on the sale of part of the undertaking was available for dividend—upon the principle, apparently, that there was nothing in the Companies Acts themselves to prevent a company declaring that one of the 'objects' for which it was incorporated was, from time to time, as opportunity offered, to sell at a profit undertakings which had in the first instance been acquired not for the purpose of re-sale, but with the idea of working them for revenue purposes. That is to say, there is no statutory provision to prevent a company from changing its mind, and deliberately converting fixed assets into current assets. To some extent, however—although to no unreasonable extent—this somewhat general decision was limited by the late Mr. Justice Byrne in the case of *Foster v. The New Trinidad Lake Asphalt Co. Ltd.*, decided in 1900. Shortly stated, the position here was that the company had in the first instance acquired a number of miscellaneous assets for a lump sum, and had—doubtless in the exercise of a bona fide discretion vested in the directors—apportioned the purchase price over the various assets so acquired. One of these assets was a book debt of an extremely doubtful nature, which was valued at *nil*, but which eventually produced to the company the sum of £26,258 16s. The directors sought to regard the *whole* of this sum as profit, doubtless on the footing that the asset in question had cost the company nothing and that therefore whatever it actually realised was clear profit. On a motion on behalf of debentureholders and a shareholder to restrain the application of these moneys to the payment of a dividend, his lordship made an order in the terms applied for. In doing so, however, he said: 'It is clear, I think, that an appreciation in the total value of capital assets, if duly realised by sale or getting in of some portion of such assets, may be a proper case to be treated as available for purposes of dividend'; but he held—and accountants will doubtless agree with his holding—that so material a disproportion between the directors' original apportionment of the purchase price among the assets acquired and the realisable value of one of those assets clearly suggested that, before any such alleged profit as that referred to could safely be treated as true profit, the whole business of the apportionment of the purchase price ought to be gone over afresh. Had the directors been prepared to re-value all their fixed assets, and after such revaluation to treat as profit only the excess of the bona fide value of the fixed assets retained

plus the proceeds of assets realised, over the original cost of all assets, there can, it is thought, be little doubt that his lordship would have sanctioned a dividend paid out of profits so computed.

Another important decision in this connection is that of Lord (then Mr.) Justice Farwell in the case *Bond v. Barrow Haematite Steel Co. Ltd.*, decided in 1902. It is thought that most accountants will find difficulty in accepting the principle apparently enunciated by his lordship towards the end of his judgment, that 'fixed' and 'current' assets are interchangeable terms. The proper distinction between fixed and current assets must, it is thought, always rest with the *intention* of the parties owning such assets, and the manner in which they propose to utilise them; and although it may be permissible for an undertaking to change its views with regard to particular assets from time to time, provided such change of views be made bona fide, the suggestion that no real distinction between the two classes of assets exists is one that may produce confusion. It must nevertheless be conceded that a stock of raw materials held by a manufacturing undertaking and the plant and machinery of the undertaking have this in common—that both represent part of the cost of future output. This point of resemblance, though important, does not justify the conclusion that there is no real distinction between fixed and current assets. However, in spite of the weakness in this respect of his lordship's argument, it is thought that no fault can be found with the general conclusions arrived at. The *crux* of the case that Mr. Justice Farwell had to decide was whether the shareholders of a company, or any class of shareholders, had an absolute, inalienable right to dividends out of profits that had clearly been earned; or whether the position was not that it was for the company in general meeting (subject to such limitations as may have been imposed by its articles) to decide what dividends are to be paid, leaving to individual shareholders merely such rights of preference *inter se* as the articles have provided. This latter, no doubt, is a correct interpretation of the position. Preference shareholders have a right to their prescribed preference dividend before more deferred shareholders receive anything whatever; but they have themselves no right to receive anything by way of dividend until it is duly voted to them. In an extreme case, if it could be shown that a majority of ordinary shareholders were corruptly taking advantage of their statutory rights to defraud a minority of preference shareholders, Equity would no doubt intervene; but it would require a very strong case before the Courts would interfere between two classes of shareholders in so purely domestic a matter as the treatment of available profits.

Another case that should be noted, though it is of restricted application, is *Re Spanish Prospecting Co. Ltd.*, which is of interest in that it indicates that where the manager of a company is entitled to a commission on the profits (if any) arising from the business of the company which may from time to time be available for such purpose, the audited accounts, even after they have been adopted by the company in general meeting, are by no means conclusive for the purpose of determining the amount of 'profits' on which such commission is

to be paid. In particular, it is there decided that where assets have been undervalued and where, therefore, on the winding-up of a company these are sold at a profit, such profit on realisation may in certain circumstances be deemed to be 'profits arising from the business of the company' for the purpose of determining the commission payable to the manager.

The decision in the case of *Ammonia Soda Co. Ltd. v. Chamberlain* also merits careful study; it is important, however, that the effect of this decision should not be exaggerated. Mr. Justice Peterson expressly stated that he was 'not going to lay down any precise and hard and fast rules which would embarrass business men in the conduct of their business as to whether dividends should be paid, or the profits, in such cases as this, should be devoted to the making up of lost capital'. The fact remains, however, that in this particular case he held that the defendants (who were formerly directors of the plaintiff company) were not liable for the payment of dividends paid out of profits earned subsequently to 1911, the claim being based on the contention that such profits ought not to have been divided, but applied towards the recoupment of losses incurred prior to 1911. The fact that these earlier losses had been written out of the books by writing up the value of the company's fixed assets had, of course, little to do with the matter at issue. It seems that his lordship saw no objection to the writing up of fixed assets where there is a bona fide belief that their actual value is in excess of their book figure. It is important to bear in mind, however, that the Courts seem to distinguish between the writing up of assets with the object of writing off past losses, and the writing up of assets with a view to creating a credit balance on current revenue with a view to its subsequent distribution. The decision in *Bolton v. Natal Land & Colonisation Co. Ltd.* (although necessarily obscure in view of the inadequacy of the report), seems to hinge on this point.

Another important decision is that of Mr. (later Lord) Justice Younger in the case *Wall v. The London & Provincial Trust Ltd.*, the effect of which is that a company which, by its articles of association, has adopted the double-account system cannot apply a profit arising from the redemption of its debentures at a discount in payment of a dividend upon its shares. But, inasmuch as his lordship stated quite clearly that, if the company wishes to apply this profit towards the payment of a dividend, it would have to alter its regulations so as to free itself from the double account system, it seems to follow (although the point was not, of course, actually decided) that, in his lordship's opinion, an ordinary commercial company *can* treat as profits available for dividend a profit made by redeeming its debentures at a price below the price of issue. If this be sound law, it seems to follow naturally that a company may treat as divisible profits the premiums received on an issue of debentures.

THE AUDITOR'S POSITION. From what has already been said it will be apparent to the reader that this subject is the lawyer's happy hunting ground; but the student and the practical auditor

may draw comfort from one thought. In the overwhelming majority of cases met in actual practice no doubts whatever arise. And where doubts do arise as to the *legality* of a distribution the auditor (who is not expected to be a legal expert) may effectively safeguard his own position by stating the facts in his report—which, after all, is his whole duty. The auditor may, also, usefully remember that questions of policy (e.g. the financial advisability of draining the company of cash) do not concern him unless they are accompanied by questions of propriety.

REVENUE RECEIPTS. These somewhat exceptional points being thus disposed of, the right conception of the effect of more ordinary transactions may now be considered. For this purpose it will be convenient to classify the various items appearing on both sides of a revenue account, which in the net aggregate show the profit alleged to be available for dividend. On the credit side these items may be conveniently classified under the following headings:

- (a) Profit on transactions completed but not yet received in cash.
- (b) Profit on transactions not completed, whether received in cash or not.
- (c) Profit on transactions completed and received in cash.
- (d) Profit arising from an estimated rise in the value of current or fixed assets.
- (e) Profits not properly incidental to the nature of the business carried on.

With regard to (a) transactions completed but not yet received in cash, it is hardly necessary to add to what has already been said in the preceding chapters; but the principles there enunciated may be summarised as follows: It is necessary to consider

- (1) Whether it may fairly and reasonably be anticipated that the debt will be discharged in due course.
- (2) Whether any allowance or discount is likely to be claimed when the debt is discharged; and
- (3) Whether it is necessary to allow for the loss of interest incidental to the deferred payment of such debt.

The points which arise on (b) transactions not completed deserve rather fuller consideration. Work in progress is a prominent example of a revenue credit falling under this head. Just as stock-in-trade is inserted at its cost (or less) with a view, in effect, to excluding from the debit side the costs incurred in procuring the stock, so in the case of work in progress it is permissible to value it as the equivalent of *all* the costs incurred in the manufacture down to the stage of completion reached; in other words, not only does work in progress attract direct labour and material costs, but it may properly include a due proportion of overhead charges incurred strictly in and about the manufacturing process. Distributive and all other costs should be rigorously excluded. It is hardly necessary to refer to the value of reliable cost accounts in the connection now under discussion.

Sales for future delivery raise a rather different point. Is a company

entitled to take credit for profit expected to be earned in respect of orders booked for future delivery? The point is one of importance in some industries, as, for example, in the wine trade, where orders are frequently booked for future delivery. Coal merchants, cotton merchants, and the like, also habitually enter into contracts to supply their goods for some time in advance. The general rule which has been laid down in this work is, it is thought, unquestionably the safe one to adhere to in all cases, namely, that the profit on the sale of goods should be taken credit for at the time when the sale actually occurs; and where it is an essential term of the contract of sale that the goods shall not be delivered until some future date, then the real question is, at what point of time does the property in the goods pass? Admirably clear rules on this point may be found in the Sale of Goods Act, 1893. If the property has passed, then there seems to be no reason why a profit should not be brought to credit, subject to the usual inquiries as to the value of the debt. If, however, the property has *not* passed, i.e. if there is only a contract to buy, as distinct from a conveyance of the goods, the case is quite different; and it is clear that the utmost measure of the profit which can be regarded as earned is the net amount which can be recovered from the other party on suing him in respect of a breach of his contract. Even where it is decided that credit may reasonably be taken for such future sales, it is important to remember that, when payment is delayed, a reasonable rebate should be made for loss of interest, and under no circumstances could any harm be done by postponing the whole of the profit until the period when the goods were actually delivered.

In the case of financial companies underwriting issues of shares or debentures, it appears to be improper to take credit as a profit for any commission upon such underwriting in respect of that portion of the various issues which had been allotted to—and still remained in the hands of—the company by reason of the subscriptions from the general public being insufficient. The nature of an underwriting agreement is that, in consideration of a certain commission, the underwriter agrees to take up a certain portion of the issue if the public do not subscribe enough to take up the whole amount among themselves. In the event of the public subscriptions being insufficient, therefore, the contract has the effect of obliging the underwriter to acquire a certain portion of the issue at a discount; and that is the view which, it is submitted, the auditor should take of the transaction. If this view be adopted, it necessarily follows that until such shares or debentures are disposed of, or until there is a realisable market value, they should appear as an asset in the accounts of the underwriter, not at their face value, but at cost price; that is to say, the underwriting commission should be dealt with, not as a profit, but as a reduction from the actual cost of the shares or debentures, as the case may be. *A fortiori* if assets are sold for payment in 'paper', no profit should be taken credit for until that paper is actually realised in cash, or acquires a genuine market value.

(c) Profit on transactions completed and received in cash is a profit which attracts no comment other than the statement that, in the eye

of the accountant, nothing more clearly represents his view of 'things as they should be'.

When, however, we come to (d), profit arising from an *estimated* rise in the value of current or fixed assets, we meet a very different case. Current assets are easily disposed of in the discussion. In view of the fact that they are held with the intention to realise them they are properly taken into account at the end of a period at an amount not in excess of their then current value, and the word 'estimated' here has no adverse significance, because, until a buyer is actually found, *all* statements of current values must necessarily be estimates. In the interest of accuracy, however, it must be said that it would be imprudent in the extreme to carry to profits an increase of value of floating assets which is a mere temporary affair, obviously without any probability of reasonable permanence.

With regard to fixed assets, the decisions make it clear that there is no rule which makes it in all cases improper to take credit for a rise in value on a bona fide revaluation; but this statement is subject to the very important reservation that in all cases a rise in value cannot be distributed till realised and it must be arrived at after a fair review of the value of *all* the fixed assets. Needless to say, too, the proposed distribution must not be repugnant to the company's own regulations, nor must it be likely to react prejudicially on the company's creditors. (See *Ammonia Soda Co. Ltd. v. Chamberlain*.)

It may be thought that the decision of Romer, J., in the case *Bolton v. The Natal Land and Colonisation Co. Ltd.*, justified the procedure adopted by the defendant company, of increasing the value of its landed property as a set-off against a loss made by way of book debts with the object of enabling the profit and loss account to show a credit balance irrespective of such loss by bad debts. It is true that in the course of his judgment (*vide* Appendix B) his lordship expressly stated that it was not correct in estimating the profits of a year to take into account the increase or decrease in the capital value of the assets of the company; but inasmuch as the lands of a company of this description would be current rather than fixed assets, this limitation might well be regarded as not bearing on the point at issue. It is thought, however, that the real effect of his lordship's decision will be found to amount to nothing more than this: In determining whether or not the excess of current revenue receipts over current expenditure is divisible, it is not necessary for a company to charge against such receipts losses sustained in prior years; and if it likes to conceal such losses by writing up the value of assets, that does not affect the matter one way or the other.

(e) Profits not properly incidental to the nature of the business carried on. Article 73 of Table A of the Companies Act, 1862, provided that 'no dividends shall be payable except out of the profits arising out of the business of the company'; that is to say, arising out of transactions that come within the 'objects' for which the company was formed, as set out in its memorandum of association. The revised Table A of 1906 modified this provision, however, by Clause 97, so as to read, 'No dividend shall be paid otherwise than

out of profits', and the same clause appears (as No. 116) in the Table A appended to the Companies Act, 1948. It is submitted that the latter form is less restricted in its terms, because it clearly leaves the company free (in proper circumstances) to distribute *capital* profits, i.e. an element of profit is a condition precedent to every dividend though (it is submitted) the necessary profit may arise out of revenue, or out of capital, or both. Inasmuch, however, as Table A is not compulsory, and is in the majority of cases superseded by special articles of association, it will be seen that these provisions are limited in their application to companies registered without articles, or with articles which do not exclude, or are in terms identical with, those already quoted.

REVENUE EXPENSES. Turning now to the expenses recorded on the debit side of the revenue account, these may conveniently be classified under the following headings:

- (a) Expenses properly chargeable to the period under review.
- (b) Expenses which may properly be spread over a term of years.
- (c) Contingent liabilities.
- (d) Depreciation.
- (e) Losses arising by fluctuation of current assets.
- (f) Losses arising by fluctuation of fixed assets.
- (g) Preliminary expenses.

With regard to (a), expenses properly chargeable to the period, it is obvious that these amounts should all be charged against the current year's revenue, and the steps which have been indicated in the preceding chapters should be taken to see that everything coming under this heading has been so charged.

Passing to (b), expenses which may properly be spread over a term of years, it should be remembered that the onus of justifying the carrying forward of this class of expenditure rests on the directors and auditor and that the auditor must, therefore, before passing the accounts, satisfy himself that the reasons advanced for its exclusion are sufficient. Examples of items which may properly be held in suspense are dead rents paid in excess of royalties by mining undertakings, where there is a reasonable ground for supposing that they can be redeemed out of future earnings; and also special expenditure in the way of advertising a new venture or undertaking, which expenditure, on a conservative estimate, need not be maintained after the venture has been once established. With regard to the latter, however, special care is necessary, with a view to deciding whether a sufficient sum should be written off annually, as it not infrequently happens that the expectations of the managers are not realised and that the permanent cost of advertising is far more than had been anticipated.

With regard to (c), contingent liabilities, it has already been stated that these must be noted on the balance sheet. The most usual matter concerned is the liability on unmatured bills under discount, but a modern instance which deserves mention is the case where a movement of exchange has adversely affected a liability to be liquidated

in a foreign currency which is inserted in the balance sheet at the rate quoted on the day thereof. In cases where contingencies form an important and customary part of the total liabilities (e.g. the negotiation by banks of acceptances on behalf of their customers) it is usual to treat the matter on both sides of the balance sheet; though in this case the circumstances are, no doubt, affected by the fact that two balances arise out of the book-keeping necessarily adopted and, of these, the debit is, in all probability, fully or partially secured.

It is unnecessary to add anything on (*d*), depreciation, to what has been said in the preceding chapters, where the matter has already been fully dealt with.

Passing on to (*e*), losses arising by fluctuation of current assets, it may be pointed out that, inasmuch as the definition of 'current assets' is that class of assets which it is the object of the undertaking to convert with all convenient speed into cash, it is obvious that, as far as possible, nothing in excess of the current net realisable value should be attached thereto on the face of any balance sheet. Special circumstances may occasionally modify this, where at the moment of balancing there has been a wholly unexpected and *temporary* fall in value which has been recovered before the issue of the accounts.

(*f*) Losses arising by fluctuation of fixed assets. Concerning this item, it is thought that, as long as the permanent earning capacity of the fixed asset has not diminished, it is unnecessary for any provision to be set aside, with a view to making good a loss which may have occurred by reason of the fluctuation of the value of such assets. Certainly the legal decisions which have been given in similar circumstances would appear to support this view. It is important to remember, however, that if the views already expressed with regard to fluctuations *upwards* in fixed assets have been disregarded, and credit has been taken for such fluctuations as a divisible profit, then *a fortiori* it is necessary that fluctuations downwards should be taken into account.

(*g*) It is usual (though not obligatory unless articles direct), to write off a portion of the amount incurred by a company in preliminary expenses—say, one-third or one-fifth—in each year's accounts until the amount is wholly extinguished. Should the first year's accounts show a loss, however, it is distinctly preferable not to obscure the facts of the case by increasing such loss by writing off any portion of the preliminary expenses. On the other hand, where there is a reserve and the accounts for the current period show a loss, a transfer of such loss should be made to the debit of reserve, so far as the latter is sufficient for the purpose, it being a contradiction in terms to state a loss on one side of the balance sheet, and a reserve (i.e. an accumulation of undivided profits) on the other side.

Where allocations of profit are made, e.g. for the writing down of goodwill or to the statutory 'Capital redemption reserve fund' in connection with redeemable preference shares, the considerations are not quite the same as in the case discussed in the preceding paragraphs. Such transfers do not diminish the *amount* of profits *earned*, but obviously affect their *applicability* to purposes of dividend.

INTEREST DURING CONSTRUCTION. All payments by way of interest are clearly primarily in the nature of revenue payments, and unless the net revenue is sufficient to cover such payments the practical result must in all cases be that they are paid out of capital, whatever lawyers may say to the contrary. If, however, the interest is payable to creditors, there is nothing improper either in paying off the liability or in debiting the payment to revenue, whether there is a profit or a loss, as the capital of a company may properly be applied in the payment of its debts; if profits be made subsequently, the interest payments can be charged against them then, and the original capital restored.

Speaking generally, it is illegal to pay interest on share capital paid-up, out of capital, because capital can only be expended in furthering the 'objects of the company', and because there is an implied contract between the company and its creditors that the capital will be applied in that way and in no other. The legislature, however, admits of certain exceptions to this rule: in the case of Parliamentary companies the payment of interest to shareholders during construction may be authorised by Special Act: in the case of companies registered under the Companies Acts, it is permitted—subject to the safeguards imposed—by Section 65 of the Companies Act, 1948 (*vide* Appendix A). The practical justification in each case, of course, is that the payment of interest to shareholders at a low rate during construction is really the most economical way of financing such construction.

In the case of Parliamentary companies, such interest is invariably debited to capital expenditure permanently. Under the 1948 Act it is charged as part of the cost of the construction of the relative works, and the accounts of the company must show the share capital on which, and the rate at which, interest has been paid out of capital during the period to which the accounts relate. The amount so debited may subsequently be written off, but there is nothing to compel the company ever to charge it against revenue.

PROFITS PRIOR TO INCORPORATION. In practice the contract of sale of a going business to a new company generally transfers the undertaking to the latter as from a date prior to the date when the company is entitled to carry on business: any profits earned during the intervening period must be treated as a reduction of the price paid for goodwill; and, similarly, any loss sustained must be regarded as an addition to the cost of goodwill. The necessary apportionment of profits, or losses, is not necessarily to be made on a purely time basis: it must be made by the directors, having regard to *all* the material facts and circumstances.

LOSSES AND SUBSEQUENT PROFITS. A question that often arises in practice is whether a company, which in the past has made losses, is justified in dividing current profits without first making these earlier losses good. At one time the general view among professional accountants was that such distributions ought not to be made, and there can be little doubt as to the inherent soundness of this

contention. But there is all the difference in the world between that which is economically unsound and that which is unlawful. If a company sustains losses in excess of any previously accumulated profits, *pro tanto* its capital is depleted. Unless those losses are subsequently made good its capital remains permanently depleted, and this (normally) will have an appreciable effect upon its subsequent earning capacity. But, while the law prohibits the distribution of capital in the form of dividend, it places no embargo on the loss of capital; indeed, it may be said that one of the objects of capital is to provide a fund that may be adventured—and, if need be, lost—in pursuance of the 'objects' for which the company was formed. There is nothing in the Companies Act to say that losses so sustained must be made good before any subsequent dividends are declared, and the judgment of Halsbury, L.C., in *Dovey v. Cory* (*vide* Appendix B) certainly seems to confirm the view that profits earned are not automatically capitalised merely because, of necessity, prior losses have been capitalised. The more recent decisions in *Ammonia Soda Co. Ltd. v. Chamberlain and Another* and *Stapley v. Read Brothers Ltd.*, are to the same effect. If this statement of the law be sound with regard to the treatment of losses on revenue account, it follows *a fortiori* that capital losses incurred in the past need not be made good before applying current profits towards the payment of dividends—and this seems to be the best justification for such decisions as that in *Cox v. Edinburgh and District Tramways Co. Ltd.*

IN CONCLUSION, it may again be pointed out that there are two distinct points of view—the financial and the legal. From the financial standpoint the 'cash' basis, as applied to commercial accounts, although often most fallible, has a very substantial utility, as applied to the revision of the results arrived at by means of the ordinary revenue account. The primary object of every revenue account is, of course, to arrive at the true net profit earned during the period under review; but in the case of the great majority of undertakings not the least important use to which the revenue account will be put is to determine the amount of such profits *available to be drawn out of the business* and distributed among the proprietors in the case of a company or a partnership, or withdrawn by the sole proprietor in the case of a business owned by an individual. The terms 'net profit' and 'profit safely divisible' are by no means interchangeable; for unless the working capital be abundant, profits cannot prudently be drawn out of the business until they have been actually realised in cash. It therefore follows that, in the great majority of cases, a safeguard—and at the same time an easily applied rough check upon the accuracy of the revenue account—is afforded by looking at the balance sheet, and seeing whether it would be practicable to draw out of the business the whole of the profits alleged to have been made, and whether there would then remain a sufficient balance of 'liquid' assets available to meet the ordinary requirements of the business. Unless such a sufficiency would remain after dividing profits up to the hilt, it is clear either (1) that such profits have not been realised, or (2) that they have

been employed as working capital, or (3) have been absorbed by, or are required for, the replacement of fixed assets at enhanced prices; in any of which events it would be impossible to distribute them without causing financial embarrassment.

The legal aspect of the matter is far less easy to understand. The law of England has made no attempt to frame one general rule to cover any and every case which may arise. Its policy is rather to treat directors as competent and prudent business men until the contrary is proved, and in consequence to be slow to interfere with a decision of directors reached after bona fide consideration. While the Courts are ready to condemn a dividend which no reasonable business man would support, it is perhaps hardly possible to sum up their method of approach to particular complaints brought before them otherwise than by saying that they refer first to the regulations of the company and next to the circumstances of the particular case in the light of evidence tendered by competent and experienced witnesses, who can interpret the facts by reference to the ordinary practice of business men.

CHAPTER XI

THE DUTIES AND RIGHTS OF AUDITORS

THE duties of auditors in specific relation to the technical performance of their routine functions have already been considered throughout the course of this work; it is now deemed advisable to devote a short chapter to the more general duties thrown on them by law, including reference to the rights to which they can lay claim.

The duties of auditors may conveniently be considered as arising under three heads, viz.:

- (a) Professional etiquette.
- (b) Common law.
- (c) Statute.

AUDITORS' DUTIES ARISING OUT OF PROFESSIONAL ETIQUETTE. These duties have shadowy boundaries which (as in the case of the ordinary rules of good conduct) every man must define for himself, but they have a very real existence. Obviously they apply with special force to members of the recognised bodies, though there is nothing to prevent other persons placing themselves, by a process of self-imposition, under the same code. The rules of professional etiquette then, may be divided into two parts as (i) those which are 'written' and embodied in the published regulations of the various bodies, and (ii) those which are 'unwritten' but which are so generally understood as to be binding. Although these two classes of rules are, for convenience of statement, divided in this way the real and practical difference between them lies in the 'sanctions' which follow their breach. A breach of the written rules exposes a member of the body concerned to the risk of expulsion or suspension from membership; and, as long as the body acts in accordance with its rules and uses its powers in a manner which does not contravene what ordinary and reasonable men regard as the principles of natural justice, the member in default has no remedy. To this extent, as will be perceived, the rules of a body become part of the ordinary law of the land, through a kind of delegation of legislative power, and are as binding on a member as rules promulgated through the ordinary channels of the law.

The regulations of the Institute of Chartered Accountants in England and Wales are contained in the Supplemental Royal Charter of 1948 and the Bye-laws made thereunder. By this Charter, the regulations of the original Royal Charter of 1880 were revoked; the historical preamble is preserved. Of the present regulations the most important are the rules which are regarded by the Institute as so essential that they are expressed to be 'fundamental'. They are contained in paragraph 20 of the Supplemental Royal Charter of 1948, which reads as follows:

20. The rules next hereinafter set forth shall be deemed fundamental rules of the Institute (that is to say):

- (1) A member shall not allow any person not being either a member of the

Institute or in partnership with himself as a public accountant to practice in his name as a public accountant.

- (2) A member in practice shall not directly or indirectly allow or agree to allow of participation by any person other than a public accountant or a person in the regular employment of the member in the profits of his (the member's) professional work without the consent of the client of such member or of the person fixing his remuneration: Provided that nothing herein shall prevent any member paying or agreeing to pay any sum out of his profits or remuneration to any retiring partner of the member in his business of public accountant or the personal representative or the widow or dependants of any such deceased partner of the member whether such partner had retired from practice or not at the date of his decease or to any predecessor in the member's business of public accountant or to the personal representative of such predecessor.
- (3) A member in practice shall not accept or agree to accept any part of the profits or remuneration of any person other than a public accountant or a person in the regular employment of the member in his practice without the consent of the client of such member.
- (4) A member who is in the employment for reward of a person (other than a member of the Institute in practice) or of a firm (other than a firm of public accountants wholly or partly composed of members of the Institute) or of a company or association carrying on or transacting any business which in the opinion of the Council is ordinarily carried on or transacted by a member of the Institute in practice shall not on behalf of such person firm company or association carry on or transact any such business in his own name.
- (5) A member in practice shall not follow any business or occupation other than that of a public accountant or one which in the opinion of the Council is incident thereto or consistent therewith. Save that where at the date of this Our Supplemental Charter the business of a public accountant is being carried on by a member either by himself or as a partner in combination with some other business and such combined business was being carried on at the date of the said Original Charter this rule shall not apply to a member of the Institute who continues to carry on that same combined business or after the date of this Our Supplemental Charter becomes engaged in that same combined business either by himself or as a partner. Provided that this saving shall cease to have effect in relation to any such combined business at the end of ten years after the death or retirement of all members of the Institute carrying on the said business either alone or as partners at the date of this Our Supplemental Charter.

With regard to the 'unwritten' rules, their whole spirit seems to be but a particular application of the much wider moral rule 'do unto others'. It is easy, for example, to see why it is desirable that no practitioner should interfere in or advise on a case with which another practitioner is already dealing, unless at the invitation of that practitioner himself. Further, it is generally understood that where one auditor is about to give up an engagement, or has been deprived thereof, another auditor does not step into his place without first referring to his colleague and giving him an opportunity of making observations. In 1937 the Council of the Institute of Chartered Accountants passed the following resolution:

'Where a change of auditors of a company is proposed, it shall be the duty of any member of the Institute before accepting nomination for election to communicate with the existing auditors with a view to ascertaining the circumstances in which a change of auditors is proposed. Compliance with the duty above referred to will not necessarily preclude the Council from considering any complaint which may be made under Section 20 (3) of the Royal Charter [now Clause 21 (3) of the Supplemental Royal Charter].'

Some years later the Council passed a further resolution in the following terms:

'The appointment of an auditor by a private individual or partnership is a matter wholly in the discretion of such private individual or the members of the partnership and in this respect differs from nomination by a member of a company as such where the interests of other shareholders are concerned. Nevertheless it is the view of the Council that in all such cases a member requested to act should, as a matter of professional courtesy, communicate with his predecessor (even if he has resigned) before accepting the appointment.'

This rule, obviously, does not operate so widely as to give an auditor a freehold in his appointment, but it creates a very desirable solidarity which is calculated to make clients think twice before persisting in an obstructive attitude.

Breach of the unwritten rules does not lead to disciplinary measures on the part of the Institute of Chartered Accountants unless so gross as to amount to an 'act or default discreditable to a public accountant or member of the Institute'; such an act may lead to exclusion from membership, or to suspension for a period not exceeding two years, after the member accused has had an opportunity of being heard. If in the opinion of the Council the member has been guilty of conduct not sufficiently serious to be visited with exclusion or suspension he may be reprimanded or admonished. Apart from this rule it is broadly true to say that a member who habitually ignores the accepted standard of ethical conduct finds himself quite unmistakably 'beyond the pale' in professional circles.

Although there is no express provision in the Charter of the Institute on the subject, it has repeatedly been laid down by the Council, and ought by this time to be well known, that members are not allowed to advertise, nor seek any publicity in a manner unbecoming to professional men.

There is a further unwritten duty to keep inviolate the confidence of clients who disclose information in the course of professional relationships.

The Council of the Institute has often ruled that it is unprofessional for a member to give estimates of future profits of an undertaking for insertion in the prospectus of a new company. The ground of this attitude is that the training and experience of a chartered accountant do not equip him to foretell the future. There is, of course, nothing to prevent a chartered accountant from making estimates for the information of private clients, though, doubtless, the advisability of indicating where statements of fact pass into statements of opinion will be clear to all readers.

AUDITORS' DUTIES ARISING OUT OF COMMON LAW. The duty of an auditor is owed to the party appointing him and is fulfilled by the performance of the terms of the *contract* between him and such appointors. The performance must be carried out with an absence of negligence, i.e. with such skill and care as are usually and reasonably observed by professional auditors and by persons holding themselves out as technical experts in accounting. An auditor cannot shelter himself behind the carelessness or incompetence of his clerks.

It will be observed that the scope of the duties in a particular engagement can be limited in any required way by the terms of the contract of appointment. The desirability of a clear preliminary understanding between the parties, recorded in writing, is too obvious to need emphasis. A contract to 'audit' books is a contract to perform a complete audit and there should always be a specific record of the respects in which the agreed examination of the books is to fall short of a complete audit; in particular it is essential that if the possibility that fraud exists is to be excluded, or if any or all of the entries in the books of original entry are to be taken as correct without examination the fact should be stated beyond the possibility of doubt. The point in mind is admirably illustrated by the two cases *Smith v. Sheard* [1906] and *Trustee of Apfel v. Annan, Dexter & Co.* [1926] reported in Appendix B.

It was stated at the head of this section that the duty of an auditor is owed to the party appointing him; this statement is important because a party suing on a contract must be able to prove 'privity of contract' and therefore persons not parties to the original contract cannot ordinarily recover damages in respect of the negligence of an auditor. This principle has been challenged in the United States, notably in the case *Ultramares Corporation v. Touche, Niven & Co.* which is reported in *The Accountant* dated 14th February, 1931, as having been heard by the Supreme Court of the State of New York. The case ended indecisively, having been settled out of Court in course of appeal, but it is interesting as indicating a danger to which auditors might be exposed should English law develop in a certain direction. Auditors were employed by a client to produce a balance sheet and they seem to have had effective notice that the accounts would be used for the purpose of obtaining credit from a banker, if only for the reason that numerous copies were finally delivered. In point of fact, however, the actual lender who afterwards came into litigation had never before made advances to the company. The balance sheet was seriously defective by reason of fraud in the clients' office and a banker who advanced money on the strength of the balance sheet and who was involved in consequence in considerable loss sued the auditors to recover. These facts evoked two careful articles in *The Accountant* (14th and 21st February, 1931), from which the following extracts are made. It will be seen that the conclusion reached is that in England an auditor is protected from actions by third parties with whom he has made no contract. After stating that, where negligence is alleged, one must 'look first for a duty commonly acknowledged by opinion to exist', *The Accountant* points out that 'the Courts of England have been slow to extend the sphere of negligence beyond the immediate interest of parties who enter into contract' and goes on to state that 'the cases in our books where negligence has been extended for the benefit of third parties are exceptional in the sense that they fall into clearly defined classes'. The article then proceeds:

'It seems to us to be quite clear that upon this side of the Atlantic an action against accountants in similar circumstances would fail for lack of the element of duty, always postulating, of course, that no instructions were expressed, or could be implied, between the third party and the accountant. To hold otherwise

would, as it seems to us, lead to fantastic consequences. By parity of reasoning, for example, the proprietors of a newspaper might be held responsible for action taken by their readers on information contained in any particular day's issue. It is always open for a party into whose hands a balance sheet comes to inquire of the accountants as to the degree of reliance which can be placed on the figures disclosed. On such inquiries, the accountant has an opportunity to consider his position in the light of the particular purpose for which the balance sheet is to be used. Without such opportunity of consideration, it seems to us that the accountant would be placed in an impossible position. He could afford to part with no balance sheet until he had made an exhaustive examination, and he would never know whether a claimant might suddenly come forward with a claim arising out of circumstances which had never been foreseen. The cost of the employment of an accountant would thus become prohibitive.'

There was a second line of argument in the *Ultramares* case to the effect that the auditors, in making the statements contained in their report, were guilty of fraud. It is, of course, well settled that fraud may be a cause of action between persons who are not bound to each other by contract in any way whatever. This point may, however, be disposed of by another quotation from *The Accountant* (21st February, 1931):

'To sum up, then, while we cannot pretend to be familiar with the American interpretation of English law, we must state our clear view that if such a claim were brought in England as the result of an audit carried out under the ordinary conditions, the claim would fall upon the grounds enunciated in *Derry v. Peek*. In such cases plaintiffs must prove each one of the four following points, viz.: (a) that the statement was untrue in fact; and (b) that the person making it knew (i.e. believed) it was untrue, or was culpably ignorant (that is, recklessly and consciously ignorant) whether it was true or not; and (c) that the statement was made to the intent that plaintiff should act on it; and (d) that plaintiff did act in reliance on it and suffered damage. We can understand that the Ultramares Corporation did act in reliance on a statement which was untrue in fact but our reading of the report does not support the view that the accountants giving the certificate either believed it to be untrue or were consciously ignorant as to its truth or untruth. We are also unable to see that the facts bear the interpretation that there was any intention that the plaintiffs should act in reliance on the certificate. For these reasons we think that English accountants need have little fear that a similar claim would be successful against them—always assuming, as we assumed in our remarks last week, that the relationship between client and accountant has not been such as directly and consciously to introduce the interest of any third party.'

AUDITORS' DUTIES ARISING OUT OF STATUTE. As has already been noted special duties are laid by Statute on the auditors of certain classes of companies. Building societies furnish an instance of a case where special acts are to be performed. We are not now concerned with these exceptional cases but with the duties laid by the Companies Act, 1948, on the shoulders of the auditors of companies registered thereunder. Section 162 provides as follows:

(1) The auditors shall make a report to the members on the accounts examined by them, and on every balance sheet, every profit and loss account, and all group accounts laid before the company in general meeting during their tenure of office, and the report shall contain statements as to the matters mentioned in the Ninth Schedule to this Act.

The Ninth Schedule to the Act is as follows:

MATTERS TO BE EXPRESSLY STATED IN AUDITORS' REPORT

1. Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit.

2. Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.

3. (1) Whether the company's balance sheet and (unless it is framed as a consolidated profit and loss account) profit and loss account dealt with by the report are in agreement with the books of account and returns.

(2) Whether, in their opinion and to the best of their information and according to the explanations given them, the said accounts give the information required by this Act in the manner so required and give a true and fair view—

(a) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and

(b) in the case of the profit and loss account, of the profit or loss for its financial year;

or, as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Eighth Schedule to this Act are not required to be disclosed.

4. In the case of a holding company submitting group accounts whether, in their opinion, the group accounts have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company or, as the case may be, so as to give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Eighth Schedule to this Act are not required to be disclosed.

In ordinary cases, where there are no group accounts and the auditor does not find it necessary to qualify his report, the report may take the following form, suggested in paragraph 35 of the Institute's booklet on the Companies Act.

Report of the auditors to the members of X. Ltd.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit. In our opinion proper books of account have been kept by the company so far as appears from our examination of those books *and proper returns adequate for the purposes of our audit have been received from branches not visited by us.* We have examined the above balance sheet and annexed profit and loss account which are in agreement with the books of account *and returns.* In our opinion and to the best of our information and according to the explanations given us the said accounts give the information required by the Companies Act, 1948, in the manner so required and the balance sheet gives a true and fair view of the state of the company's affairs as at . . . and the profit and loss account gives a true and fair view of the profit (loss) for the year ended on that date.

The words in italics should be deleted where they are not applicable.

It is also recommended that, if the accounts are not self-contained because material information is contained in paragraphs of the directors' report or in other documents annexed to the accounts, reference to the specific documents to be read as part of the accounts should be included by the auditor in his report in terms which clearly identify the source to which the reference is made.

It will be remembered that, under Part III of the Eighth Schedule, banking, discount and assurance companies are exempted from certain

of the requirements of the Eighth Schedule, and that companies of a class prescribed for the purpose by the Board of Trade are also exempt in certain respects. In such cases, the auditor is required to report that the balance sheet and profit and loss account give a true and fair view 'subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Eighth Schedule to this Act are not required to be disclosed'. It is recommended (I.C.A., paragraph 36) that the matters to be indicated in the report in such cases should be determined by the auditors according to the particular circumstances, legal advice being taken if necessary.

Under paragraph 4 of the Ninth Schedule, the auditors of a holding company must state in their report whether, in their opinion, the group accounts have been properly prepared in accordance with the provisions of the Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the holding company.

The auditors of a holding company are not always or necessarily auditors of the subsidiary companies, and in such circumstances their duty under paragraph 4 of the Ninth Schedule is an onerous one. It is clear that the auditors of the holding company must take responsibility for accepting for the purposes of group accounts the balance sheets and profit and loss accounts of subsidiaries. (See I.C.A., paragraph 151.) It is for them to decide whether they will rely upon the reports of the auditors of the subsidiaries or make further enquiries regarding the subsidiaries' accounts. They cannot, in the opinion of counsel, avoid responsibility merely by indicating in their report that the information regarding subsidiaries is based upon accounts of subsidiaries not audited by them. (I.C.A., paragraph 39.) Nevertheless, for their own protection, the auditors of a holding company should qualify their report by stating, if such is the case, that the accounts of certain subsidiaries have not been audited by them.

The Act does not specifically require that the accounts of subsidiaries used for purposes of consolidated accounts or of group accounts in some other form should be audited accounts, but it is certainly desirable that they should be. If, however, the auditors of a holding company are in exceptional circumstances compelled to rely upon unaudited accounts of foreign or other subsidiaries, they should, in the opinion of counsel, draw attention to the fact by way of note. (See I.C.A., paragraph 152.)

Group accounts are normally consolidated accounts, but they may in certain circumstances be presented in other forms. The auditors' report must, therefore, be adapted so as to correspond to the form in which the group accounts are prepared. If the group accounts are submitted in the form of separate accounts dealing with each of the subsidiaries, then, in the opinion of counsel, the report of each subsidiary's auditors must be attached to the subsidiary's accounts, unless the subsidiary's accounts have been adjusted in respect of the interests of minority shareholders or otherwise to give effect to the requirements of the Act. (I.C.A., paragraph 41.) If the subsidiary's accounts have been so adjusted, they cease to be the accounts upon

which the auditors of the subsidiary have reported, and for this reason the auditors' report cannot be attached to accounts so adjusted.

In cases where consolidated accounts are submitted, it is suggested in paragraph 37 of the Institute's booklet on the Companies Act that the part of the auditors' report which, in accordance with paragraph 4 of the Ninth Schedule, deals with the group accounts should be in the following form.

We have also examined the annexed consolidated balance sheet and consolidated profit and loss account of the company and its subsidiaries dealt with thereby with the audited accounts of those companies *certain of which have not been audited by us. Subject to the foregoing*, in our opinion such consolidated balance sheet and consolidated profit and loss account have been properly prepared in accordance with the provisions of the Companies Act, 1948, so as to give a true and fair view respectively of the state of affairs and of the profit (loss) of X. Ltd. and its subsidiaries dealt with thereby, so far as concerns members of X. Ltd., *and so far as is practicable having regard to the fact that accounts of some of the subsidiaries are made up to different dates and cover different periods from those of X. Ltd.*

The above paragraph will, of course, follow immediately after the earlier part of the report which deals with the holding company itself and which may be in the form suggested in paragraph 35 of the Institute's booklet as suitable for general use.

The reference (in italics) to certain accounts of subsidiaries 'which have not been audited by us' will, of course, not be included if the accounts of all the subsidiaries have been audited by the auditors of the holding company. If accounts of material importance are unaudited accounts, there should be a statement to that effect. The qualification (in italics) in the last part of the above form of report will not be included where it is not applicable or where the auditors are satisfied that the differences of date and period have no material effect on the view presented.

In cases where group accounts are submitted in a form other than that of consolidated accounts, it is suggested in paragraph 38 of the Institute's booklet on the Companies Act that the last part of the auditors' report should be in the following form.

We have also examined the annexed group accounts with the audited accounts of the companies dealt with thereby, *certain of which have not been audited by us. Subject to the foregoing* in our opinion the group accounts have been properly prepared in accordance with the provisions of the Companies Act, 1948, so as to give, *in conjunction with the balance sheet and profit and loss account of X. Ltd.*, a true and fair view of the state of affairs and of the profit (loss) of X. Ltd. and its subsidiaries dealt with by such group accounts, so far as concerns members of X. Ltd.; *and so far as is practicable having regard to the fact that accounts of some of the subsidiaries are made up to different dates and cover different periods from those of X. Ltd.*

It is suggested that the group accounts should be identified either by an appropriate heading to such accounts or by a reference to them in the auditors' report. The words 'in conjunction with the balance sheet and profit and loss account of X. Ltd.' (shown above in italics) will be omitted if the holding company's accounts are also incorporated in the group accounts. The other words in italics will be omitted where they are not applicable.

If, as permitted by subsection (5) of Section 149 of the Act, the

holding company's profit and loss account is framed as a consolidated profit and loss account, it does not present a true and fair view of the holding company's profit or loss for the financial year. In such cases, in the opinion of counsel, the provisions of paragraph 3 (2) (b) of the Ninth Schedule are not applicable. (I.C.A., paragraph 43.) It must be remembered, however, that a profit and loss account framed as a consolidated profit and loss account is part of the group accounts, and the auditors must therefore report on it in accordance with the provisions of paragraph 4 of the Ninth Schedule.

Where the profit and loss account of a holding company is framed as a consolidated profit and loss account, the general form of auditors' report set out in paragraph 35 of the Institute's booklet on the Act must be amended by deleting references to the profit and loss account.

It appears clear that Section 162 and the Ninth Schedule require the auditor to make one report and one only. There is no provision for a separate report on the group accounts. The statement regarding group accounts required by paragraph 4 of the Ninth Schedule is a part of the one report which the auditors are required to make.

By Section 162 (2), the auditors' report must be read before the company in general meeting and must be open to inspection by any member.

In addition to the duties imposed on auditors by Section 162 and the Ninth Schedule, the auditors of a company are also required, by Sections 196 and 197, to give in their report the information regarding directors' emoluments, &c., and loans to officers which those sections require, if the information has not been given in the company's accounts. For further details, the reader is referred to Chapter VIII.

The duties of auditors under Section 130 in regard to the statutory report have been mentioned in Chapter IV.

By Section 38 and Part II of the Fourth Schedule to the Act, every prospectus issued by a company must include a report by the auditors of the company. For further details, the reader is referred to Chapter XIII.

It is important to notice that the auditors' report in the terms required by the Ninth Schedule is partly a statement of facts and partly an expression of opinion. It is because the report refers to an expression of opinion that it must always be incorrect and misleading to call it a 'certificate'—a name which can be proper only to a statement of ascertained fact.

The precise form of the present report is the result of an interesting set of historical circumstances which may profitably be reviewed in this place. Article 94 of the original (1864) Table A provided that auditors should 'make a report to the members', and that such report should be 'read' at the ordinary meeting. Special articles of association very frequently went further, and required that the auditor's report should be printed at the foot of the balance sheet, and thus more or less be made public property. Hence arose the custom of reporting in a concise, not to say a colourless, form. In course of time it became the almost invariable practice for the auditor, after satisfying himself that the balance sheet was a full and fair balance sheet, containing

the particulars required by the company's regulations, and properly drawn up so as to exhibit a true and correct view of the state of the company's affairs, to signify the fact by signing the balance sheet, and prefixing his signature with the words 'audited and found correct', or others to the same effect; indeed the auditor's report of the nineteenth century was so little a report in the popular sense of the term that, by common consent, it was almost invariably described as a 'certificate'. This, it is submitted, was an unfortunate expression that gave rise to much misconception, in that a certificate is something that 'makes certain', and is thus necessarily limited to facts capable of absolute verification; whereas a report is something 'brought back' in answer to an inquiry, and is thus an 'account'—but not, of course, an account rendered by the accounting party. It will thus be seen that the altogether gratuitous substitution of the term 'certificate' for 'report' conveyed with it a fictitious idea that the balance sheet was a statement of fact capable of absolute verification, instead of being merely a narrative of accounting parties 'brought back' from them by an independent messenger selected for that purpose by reason of his impartiality and trustworthiness.

The evil did not, however, by any means stop with the false impression given to the general public by the adoption of the misleading term 'certificate'. By reason of the fact that it had become customary to print all that the auditor had to say as the result of his audit at the foot of the balance sheet, it became usual to reduce those comments to the barest possible minimum; in fact, there were cases in which the so-called 'certificate' consisted exclusively of the auditors' signature, without one word of comment, and the employment of the single word 'audited' or 'certified' was by no means unusual.

It is difficult to see why a quite reasonable desire for conciseness should ever have been carried to so absurd an extreme; but it is quite easy to see that the practice of publishing the auditor's report (by whatever name it might be known), however convenient it might be when everything was entirely satisfactory, might—and indeed naturally would—prove extremely embarrassing in cases where the auditor did not feel justified in expressing the view that everything was as it should be. A reference to the *London and General Bank* case will show that, while the auditor had as the result of his investigations satisfied himself that the capital of the company was locked up in assets difficult of realisation, and that no dividend could prudently be paid, he was induced to refrain from expressing this view to the shareholders on the ground that the publication of such a report would inevitably ruin the bank, and thus cause incalculable harm to the shareholders whom it was the primary duty of the auditor to defend.

To meet this difficulty, the Companies Act, 1900, was passed, which, in addition to making an audit compulsory in the case of every company, provided a somewhat complicated means of enabling the auditor to acquaint the shareholders with the results of his investigation. Under Section 23 of the Act it was provided that the auditors should 'sign a certificate at the foot of the balance sheet stating whether or not all their requirements as auditors had been complied with', and should

'make a report to the shareholders on the accounts examined by them, and on every balance sheet laid before the company in general meeting, during their tenure of office'; and in every such report should 'state whether, in their opinion, the balance sheet referred to in the report was properly drawn up, so as to exhibit a true and correct view of the state of the company's affairs as shown by the books of the company'. It was further provided that 'such report shall be laid before the company in general meeting'. It is submitted, as a pure question of interpretation, that there is only one view to be taken of the meaning of this section, namely that upon the face of the balance sheet there should appear a formal 'certificate' on the part of the auditor to the effect (substantially) that he had been afforded proper facilities to make the audit—a statement which, being a matter of fact, would be capable of certification—and that, in addition, he should report to the shareholders on the accounts to such extent as he might think necessary, which report need not be printed at the foot of the balance sheet, but must be read to the shareholders in general meeting assembled. There was, of course, nothing in the section to forbid the printing of the report at the foot of the balance sheet; but there would be no sense in distinguishing between the certificate and the report, if it had been intended that the two should form one document; and, as has already been stated, the essential requirement of the situation—as shown by somewhat painful experience—was that the auditor should have some means, definitely authorised by the Legislature, of communicating with the shareholders in a manner that would not necessarily damage the credit of the company, should the report be unfavourable.

The general practice under the 1900 Act suggested, however, that company directors, taken as a class, were not sufficiently far-seeing to appreciate that they might at some future time be glad of an opportunity of refraining from printing the auditor's report. The great majority of company balance sheets issued in 1901 and thereafter had appended to them what to all outward appearance was something combining in one document the statutory certificate and the statutory report—a practice which would have made any subsequent departure therefrom extremely inconvenient, as very prominently drawing attention to the fact that the report was unfavourable—a circumstance that might easily damage the company far more than the publication broadcast of the report itself. Sooner or later, however, such a position may arise in the life of any company, and thus arose what can only be described as a most mischievous practice—absolutely in conflict with the spirit of the Act of 1900, namely, the practice of continuing to append to the foot of the balance sheet a document which *prima facie* appeared to be a combination of the statutory certificate and the statutory report, and of at the same time issuing a fuller report to shareholders which was not printed, but only read at the general meeting—probably immediately after the notice convening the meeting and before the handful of shareholders present could properly settle down into their places.

The result was that the Companies Act, 1907, enacted what after-

wards became Section 113 of the Companies (Consolidation) Act, 1908, whereby the auditors were to make a report 'and the auditor's report shall be attached to the balance sheet, *or there shall be inserted at the foot of the balance sheet a reference to the report*, and the report shall be read before the company in general meeting, *and shall be open to the inspection of any shareholder*'. The passages italicised betray the influence of the historical development mentioned above and show that even as late as 1908 the auditor's report was conceived of as a document which might in some circumstances be of a domestic nature, although precautions were taken to prevent its total suppression.

The 1929 Act completed the process of evolution by enacting in very clear terms sections which, while preserving the wording as to the form of auditor's reports contained in the 1907 Act, yet, by omitting the words italicised in the previous paragraph and substituting provisions for actually attaching the report to the balance sheet circulated and published (under the same penalty of fifty pounds as formerly applied to neglect of the alternatives), made the auditor's report a document essentially public in its nature. (It need hardly be added that in the case of exempt private companies the connotation of the word 'public' must be modified.)

This is the place to mention that the 1929 Act effected an improvement (which is continued in the 1948 Act) by substituting the word 'members' for 'shareholders' as the persons to whom the report is to be addressed. This word is accordingly now used in the heading of all auditor's reports attached to balance sheets.

In the opinion of counsel, obtained by the Institute of Chartered Accountants in 1908, the attachment of the auditors' report to the balance sheet should be effected either by printing the two documents continuously on the same sheet of paper or by fastening the report to the balance sheet. Counsel also expressed the opinion that the best mode of attachment was that the report should be written or printed at the foot of the balance sheet or endorsed thereon.

It is *not* the duty of an auditor to take steps to secure that his report is, in fact, communicated to the members of the company. The point arose in *Re Allen Craig & Co. (London) Ltd.* (reported in Appendix B), and it was held that the auditor had discharged his duty when he had delivered his report to the secretary of the company; it was then for the directors to communicate it to the members and if no meeting was convened for this purpose it was for the members themselves to insist in protection of their own rights.

It is interesting to compare the terms of the auditor's report under the Companies Act, 1948, with the form of report currently in use in the United States of America. Apart from a relatively small number of companies which are subject to the regulations of the Securities and Exchange Commission, American companies are not subject to statutory requirements in regard to the form of their accounts or in regard to audit. The requirements of the New York Stock Exchange and the influence of the American Institute of Accountants have, however, established standards of auditing which are generally observed. The report now in use is in the following terms:

'We have examined the balance sheet of ABC Company as of December 31, 1949, and the related statements of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

'In our opinion, the accompanying balance sheet and statement of income and surplus present fairly the financial position of ABC Company at December 31, 1949, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.'

The evolution of the auditor's report in the U.S.A. has been described in an address delivered by Mr. George Cochrane, F.C.A., C.P.A., reproduced in *The Accountant* on 4th November, 1950.

Compared with the requirements of the Companies Act, 1948, the American system is flexible, in that growth and development are in no way dependent on changes in statute law.

AUDITOR AS AN OFFICER OF THE COMPANY. It has often been asked whether an auditor is an officer of the company. It appears that an auditor must be regarded as an officer for some purposes but not for others. Such was the opinion of counsel obtained by the Institute of Chartered Accountants in relation to the Companies Act, 1929, and the point has not been elucidated by the Act of 1948. Section 159 of the Act of 1948, which provides for the appointment and remuneration of auditors, includes a reference to the 'office of auditor'. Subsection (2) of Section 161, provides that 'none of the following persons shall be qualified for appointment as auditor of a company: (a) an *officer* or servant of the company; . . .' It is, however, provided in the last sentence of the subsection that 'references in this subsection to an officer or servant shall be construed as not including references to an auditor'. It may be thought that, unless an auditor is regarded as an officer for some purposes, this last sentence would be unnecessary. Section 167 (5) contains a reference to 'bankers and solicitors of the company or other body corporate and any persons employed by the company or other body corporate as auditors, whether those persons are or are not officers of the company or other body corporate'. Section 448 (1) refers to 'an officer of a company or a person employed by a company as auditor (whether he is or is not an officer of the company)'. The above mentioned passages in Sections 167 and 448 show that an auditor is not regarded as an officer for all purposes.

There are a number of sections in the Act of 1948 by each of which, if default is made in complying with its provisions, every officer who is in default is liable to a default fine. By Section 440 (2), the expression 'officer who is in default' means any officer of the company who knowingly and wilfully authorises or permits the default, refusal or contravention mentioned. The Institute of Chartered Accountants obtained the opinion of counsel in regard to similar provisions of the 1929 Act, which contained a similar definition of 'officer in default'. The substance of this opinion was that, as respects most of the relevant sections of the 1929 Act, an auditor could not be said in any ordinary circumstances to have authorised or permitted the defaults, refusals

and contraventions in question. The qualifying words 'knowingly and wilfully' provide a further safeguard.

Counsel were of the opinion that an auditor would, within the sphere of his duties, be regarded as an officer for the purposes of Sections 271 to 277 of the 1929 Act. These sections are represented (with certain amendments) by Sections 328 to 334 of the Act of 1948. Reference has been made in Chapter IV to Section 331, by which, if proper books of account were not kept by a company during a specified period before the commencement of winding up, every officer in default is liable on conviction to imprisonment unless he shows that he acted honestly or that, in the circumstances in which the business was carried on, the default was excusable. Section 333 is of particular importance, since it is under this section that, upon the winding-up of a company, any officer of the company may be held liable for misfeasance or breach of trust, and there can be no doubt that an auditor must be regarded as an officer for purposes of this section. The matter is considered more fully in Chapter XII.

Counsel were also of opinion that an auditor would probably be regarded as an officer and be liable under Section 129 of the Act of 1929, if he were knowingly a party to the issue of a copy of the balance sheet without a copy of his report.

FRAUD BY CLIENTS. One difficult subject remains to be discussed. What is the position of the auditor if he should discover, in the course of his audit and in consequence of the confidential communications made to him by his client, that the said client has committed, or is in the course of committing, a crime? Is there any duty to inform the authorities so that the law may take its course?

It may be said at once that the auditor has no *privilege* not to divulge professional communications, even in a court of law, such as is enjoyed by solicitors. The problem under discussion is that of *voluntary* disclosure. The particular matter was carefully considered in two articles appearing in *The Accountant* of 27th January and 24th February, 1912. Nothing that has happened since has impaired the authority of the statements contained therein and accordingly the following quotations are now given, although necessarily the context must be omitted.*

'It must always be carefully borne in mind that an accountant who, in the course of his professional work, discovers fraud is in a somewhat different position to an ordinary member of the public who knows that a man has committed, or is about to commit, a criminal offence. An accountant must necessarily be admitted into the full confidence of his employer, and it is only by reason of this confidential relationship that he becomes possessed of his employer's secret. To say that as a member of the public, and as a "good citizen", he ought to give information against his employer, is simply to beg the question, because the problem with which an accountant, in the circumstances we are considering, is faced, does not arise in his capacity as a private citizen, but as a professional man, who, from the peculiar nature of his duties, has to be taken into his employer's confidence. Any argument in this connection, based upon the well-known duty of a "good citizen" to which we have referred, does not carry us a step further, because it loses sight of the fundamental distinction which we have

* The Editor considers it proper to mention that the articles under quotation were from the pen of the original author of this work.—*L.d.*

pointed out between one who, by accident, and in the course of his everyday dealings, may discover criminal conduct, and another who only obtains his knowledge through being admitted to the confidence of his employer, who considers his secrets as safe in the keeping of a man whom he employs. We should be the last to advise an accountant—or anybody, for that matter—to swerve from the path of plain duty, or to pause to consider what may be the effect—immediate or ultimate—on his own personal interests; but we do conceive it possible that some might shrink from taking a step which might be regarded as the betrayal of another's confidence even at the risk of incurring censure for having fallen short in their public duty from those who would govern life by rule-of-thumb. Napoleon once said that "you cannot rule life by logic", neither can we at all times act strictly in accordance with hard and fast rules of ethical conduct. Sometimes we are forced to compromise with circumstances, and do something which we know and feel is not consistent with the highest ethical ideals. "Public interest" and "public duty" notwithstanding, if we always acted up to them, most of us would probably spend a good part of our time in laying informations at the police courts. Even judges, who are expected to administer the law as it stands, occasionally permit themselves a departure from strict practice. . . .

' . . . As a rule, public opinion finds something repugnant in the view that, once a man has entered into confidential relations with another, he can divest himself of that relationship or disclose matters which, by means of such relationship, have come to his knowledge. An accountant confronted with the problem which we are discussing has a double or, as we should prefer to put it, a divided duty: on the one hand it is quite true that he is under obligation, like any member of the public, to prevent the commission of crime; but on the other hand, we cannot altogether shut our eyes to the fact that he owes a duty also to his employer, who admitted him to his confidence, and has allowed him to share his secrets with him, in the belief that he is to be trusted with them.

'We have said that an accountant has a double duty, but perhaps it would be more correct to say that his is a three-fold obligation. He owes a duty to the public and to his employer, but he has also a duty to the profession to which he belongs. He is a member of a corporate body, and he has always to bear in mind that any act of his which the public might regard with disfavour will react upon, and do harm to, the profession at large.'

In a matter such as this every case must necessarily be unlike every other case and it must be left to every man to settle his own particular difficulty. There is, however, one clear rule which serves as a universal guide. The auditor or accountant must never allow his services to be used to further or conceal the wrong-doing of the client; still less must he run the risk that the acceptance of a fee might appear, or be made to appear, as payment for aid in the commission of a crime, or as a bribe for abetting its concealment. Where there is any suspicion of a risk in this direction the engagement should immediately be resigned. In any event the auditor should be careful to point out to his client (preferably in writing) the nature of the matters in question and should clearly and emphatically dissociate himself from them.

There is no universal rule which can settle all cases. The professional auditor will not long be in practice before he finds himself asked to put his name to accounts evidently intended to be used to evade just income-tax liabilities. The course to be unhesitatingly taken there is clear; there is no need to act the common informer, but there is need to resign the engagement at once.

THE RIGHTS OF AUDITORS. The student will perhaps consider it refreshing to be told that persons on whom so many onerous duties

are cast, and who labour under so many heavy liabilities, have any rights whatever. Yet, such indeed is the comforting truth, although it must be confessed that in this case the grain of truth is relatively small.

In the first place the auditor has a right to presume, in the absence of circumstances giving rise to suspicion, that his own client is facilitating and not obstructing the performance of the auditor's duties. This right does not allow the auditor to close his eyes to the contrary possibility but it at least allows him to concentrate his attention on the main business in hand. The presumption that an auditor is not required to be a detective in regard to the general question of fraud is dealt with in the chapter on the liabilities of auditors.

An auditor who has been appointed has no indefeasible right to take up his duties and the Court will not interfere to force him on a client not requiring his services. (See *Cuff v. London and County Land Co.* ([1912] 1 Ch. 440).)

The remuneration of the auditor has an evident practical interest which justifies the inclusion of the subject under the heading of 'rights'. Generally speaking where an auditor contracts to do a whole audit for a specific sum of money he must complete his work or get nothing, unless the parties agree to rescind the arrangement and substitute a new contract, when he may be entitled to a *quantum meruit*. If, however, completion is prevented by the client, the auditor can claim damages for the breach. It is clear that if part payment for part performance were enforceable, the Court would be making a new contract for the parties, a thing the Court will never do. Where a contract is for work and labour and a small portion is badly done, the contract being otherwise substantially performed, the agreed price can be claimed subject to a reasonable deduction for bad work; but it seems doubtful whether the nature of auditing can ever give rise to this principle.

In the case of small companies the auditor is very often expected to complete the book-keeping and to prepare the periodical accounts, as well as to perform the audit proper. Unless he has received express instructions from the directors, it is thought that he would be entitled to no additional remuneration for these extra services; but he is of course, quite entitled, if he thinks it desirable, to refuse to commence his work until the books are ready for audit.

STATUTORY RIGHTS. The Companies Act, 1948, gives certain important rights to the auditor.

It is provided by Section 162 (3) that every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the officers of the company such information and explanations as he thinks necessary for the performance of the duties of the auditors.

By Section 162 (3), the auditors of a company are entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive and to be heard at any general meeting which they attend on any part of the business of the

pointed out between one who, by accident, and in the course of his everyday dealings, may discover criminal conduct, and another who only obtains his knowledge through being admitted to the confidence of his employer, who considers his secrets as safe in the keeping of a man whom he employs. We should be the last to advise an accountant—or anybody, for that matter—to swerve from the path of plain duty, or to pause to consider what may be the effect—immediate or ultimate—on his own personal interests; but we do conceive it possible that some might shrink from taking a step which might be regarded as the betrayal of another's confidence even at the risk of incurring censure for having fallen short in their public duty from those who would govern life by rule-of-thumb. Napoleon once said that "you cannot rule life by logic", neither can we at all times act strictly in accordance with hard and fast rules of ethical conduct. Sometimes we are forced to compromise with circumstances, and do something which we know and feel is not consistent with the highest ethical ideals. "Public interest" and "public duty" notwithstanding, if we always acted up to them, most of us would probably spend a good part of our time in laying informations at the police courts. Even judges, who are expected to administer the law as it stands, occasionally permit themselves a departure from strict practice . . .

' . . . As a rule, public opinion finds something repugnant in the view that, once a man has entered into confidential relations with another, he can divest himself of that relationship or disclose matters which, by means of such relationship, have come to his knowledge. An accountant confronted with the problem which we are discussing has a double or, as we should prefer to put it, a divided duty: on the one hand it is quite true that he is under obligation, like any member of the public, to prevent the commission of crime, but on the other hand, we cannot altogether shut our eyes to the fact that he owes a duty also to his employer, who admitted him to his confidence, and has allowed him to share his secrets with him, in the belief that he is to be trusted with them.

'We have said that an accountant has a double duty, but perhaps it would be more correct to say that his is a three-fold obligation. He owes a duty to the public and to his employer, but he has also a duty to the profession to which he belongs. He is a member of a corporate body, and he has always to bear in mind that any act of his which the public might regard with disfavour will react upon, and do harm to, the profession at large.'

In a matter such as this every case must necessarily be unlike every other case and it must be left to every man to settle his own particular difficulty. There is, however, one clear rule which serves as a universal guide. The auditor or accountant must never allow his services to be used to further or conceal the wrong-doing of the client; still less must he run the risk that the acceptance of a fee might appear, or be made to appear, as payment for aid in the commission of a crime, or as a bribe for abetting its concealment. Where there is any suspicion of a risk in this direction the engagement should immediately be resigned. In any event the auditor should be careful to point out to his client (preferably in writing) the nature of the matters in question and should clearly and emphatically dissociate himself from them.

There is no universal rule which can settle all cases. The professional auditor will not long be in practice before he finds himself asked to put his name to accounts evidently intended to be used to evade just income-tax liabilities. The course to be unhesitatingly taken there is clear; there is no need to act the common informer, but there is need to resign the engagement at once.

THE RIGHTS OF AUDITORS. The student will perhaps consider it refreshing to be told that persons on whom so many onerous duties

are cast, and who labour under so many heavy liabilities, have any rights whatever. Yet, such indeed is the comforting truth, although it must be confessed that in this case the grain of truth is relatively small.

In the first place the auditor has a right to presume, in the absence of circumstances giving rise to suspicion, that his own client is facilitating and not obstructing the performance of the auditor's duties. This right does not allow the auditor to close his eyes to the contrary possibility but it at least allows him to concentrate his attention on the main business in hand. The presumption that an auditor is not required to be a detective in regard to the general question of fraud is dealt with in the chapter on the liabilities of auditors.

An auditor who has been appointed has no indefeasible right to take up his duties and the Court will not interfere to force him on a client not requiring his services. (See *Cuff v. London and County Land Co.* ([1912] 1 Ch. 440).)

The remuneration of the auditor has an evident practical interest which justifies the inclusion of the subject under the heading of 'rights'. Generally speaking where an auditor contracts to do a whole audit for a specific sum of money he must complete his work or get nothing, unless the parties agree to rescind the arrangement and substitute a new contract, when he may be entitled to a *quantum meruit*. If, however, completion is prevented by the client, the auditor can claim damages for the breach. It is clear that if part payment for part performance were enforceable, the Court would be making a new contract for the parties, a thing the Court will never do. Where a contract is for work and labour and a small portion is badly done, the contract being otherwise substantially performed, the agreed price can be claimed subject to a reasonable deduction for bad work; but it seems doubtful whether the nature of auditing can ever give rise to this principle.

In the case of small companies the auditor is very often expected to complete the book-keeping and to prepare the periodical accounts, as well as to perform the audit proper. Unless he has received express instructions from the directors, it is thought that he would be entitled to no additional remuneration for these extra services; but he is of course, quite entitled, if he thinks it desirable, to refuse to commence his work until the books are ready for audit.

STATUTORY RIGHTS. The Companies Act, 1948, gives certain important rights to the auditor.

It is provided by Section 162 (3) that every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the officers of the company such information and explanations as he thinks necessary for the performance of the duties of the auditors.

By Section 162 (3), the auditors of a company are entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive and to be heard at any general meeting which they attend on any part of the business of the

meeting which concerns them as auditors. Under Section 134 (2) of the 1929 Act, the auditors were entitled to attend any general meeting at which any accounts which had been examined or reported on by them were to be laid before the company; they were not entitled to attend any other general meetings. Under Section 134 (3) of the 1929 Act, they were entitled to make any statement or explanation they desired with respect to the accounts. Their rights in this respect have been defined in Section 162 of the 1948 Act in broader terms.

It is thought that the opinion of counsel, obtained by the Institute of Chartered Accountants in 1929, in regard to subsection (3) of Section 134 of the 1929 Act, may still be of interest, and it is therefore given in full:

'With regard to Section 134 (3) as conferring a right which will only be exercised in very exceptional circumstances, e.g. where a serious state of affairs is being concealed by directors from the shareholders. A statement or explanation made under the subsection would not relieve the auditor from responsibility for omissions in his report on the balance sheet. We are of the opinion that auditors, who avail themselves of the right conferred by the subsection will not be bound to answer questions by shareholders and we think that they would be wise to refrain from doing so, particularly without the sanction of the Board. We do not consider that an auditor incurs any responsibility, by absenting himself from an annual general meeting, in respect of questions raised at the meeting upon which his views might be asked, whether or not his views would have placed the facts before the shareholders in a different light from that conveyed to them by the directors. But an auditor who was present at a meeting would be most unwise in our opinion not to correct wrong information given by a director in regard to an item in the accounts or in respect of matters arising out of the auditors' report.'

The auditors' rights under Section 160 in the event of notice being given of a resolution to appoint as auditor a person other than the retiring auditor have been dealt with in Chapter I.

Articles of association cannot derogate from the statutory rights of auditors. (See *Newton v. Birmingham Small Arms Co.* case.)

CHAPTER XII

THE LIABILITIES OF AUDITORS

It is proposed now to consider the extent of the auditor's liability in connection with accounts that he has passed.

The question appears to be capable of division under two heads, viz.:

(1) Criminal liability.

(2) Civil liability.

The second heading will be found to fall into two subdivisions according to whether the procedure in enforcing the liability is by way of action or by way of summons under the 'misfeasance' section of the Companies Act.

CRIMINAL LIABILITY. Criminal liability arises from a course of conduct constituting a crime and the mark which distinguishes unlawful acts which are crimes from those which are civil wrongs is that a party guilty of the former is liable to legal *punishment*.

It is not proposed to devote attention to gross and obvious forms of crime whereby a guilty auditor might consciously and deliberately embark on a course of conduct clearly and criminally wrong; but rather to consider cases where errors in the performance of an audit may entail criminal consequences. Happily, the precedents are comparatively rare but, as will appear, the danger run by an auditor is not inconsiderable.

The *motive* of the act charged is immaterial, but guilty *intent*, that is, an intention to do what is known to be illegal is an essential element of a crime.

The law as to publishing false statements in connection with bodies corporate is contained (a) in Section 84 of the Larceny Act, 1861 (in conjunction with which the Falsification of Accounts Act, 1875, should be read), (b) Section 12 of the Prevention of Fraud (Investments) Act, 1939, and (c) in Section 438 of the Companies Act, 1948. It is to be remarked that in the Fifteenth Schedule of the Companies Act, 1948, the auditor's report is specifically brought within the scope of the provisions of Section 438 which declare that a false statement in any 'return, report, certificate, balance sheet' required by the Act, is a misdemeanour. Sections 43 and 44 of the Companies Act, 1948, deal respectively with civil and criminal liability for mis-statements in a prospectus.

It is now proposed to review some cases which have occurred in the criminal courts.

At the trial of the auditors and certain other officials of *Dumbell's Banking Co. Ltd.*, which took place at Douglas, Isle of Man, in November, 1900, the prosecution was under Section 221 of the Manx Criminal Code of 1872, but the wording of this section is identical with that of Section 84 of the English Larceny Act of 1861, so that the precise locality of the prosecutions introduced no distinctive element. The

defendants were convicted of having joined in the issue of false balance sheets, knowing them to be false, and with the intention to deceive, and were accordingly sentenced to varying terms of imprisonment. If it were necessary to deal at length with the merits of this particular case, much space might be devoted to a discussion of the evidence, with a view to seeing whether the charges put forward were actually proved up to the hilt in all cases; but for the purposes of a general work of reference this is not required.

Another criminal case which is of interest in this connection, although the auditors were in no way involved, is the trial of the managing director and breweries manager of *Showell's Brewery Ltd.*, in March, 1904, on various charges of fraud. The defendants, who were convicted and sentenced respectively to fifteen months' and nine months' imprisonment, had for many years systematically overvalued the stock-in-trade and had induced subordinate employees of the company to certify to these valuations on the representation that they were more than covered by existing secret reserves.

In the case of *Farrow's Bank Ltd.*, the auditor—who, in spite of Section 112 (3) of the Companies (Consolidation) Act, 1908, was in the company's regular employment as its accountant—was convicted at the Central Criminal Court, before Mr. Justice Greer in June, 1921, on various charges of conspiracy and fraud in connection with the published accounts of the bank, and sentenced to twelve months' imprisonment. In this case there had been a wholesale 'writing-up' of assets, apparently for no other reason than to show profits available for dividend. In one case a property that cost £5,500 was written up to £780,000!

But by far the biggest and most important case which has ever arisen under this branch of the subject was the prosecution at the Old Bailey, in July, 1931, of Lord Kylsant and Mr. H. J. Morland, F.C.A., in respect of certain matters connected with the affairs of the Royal Mail Steam Packet Co., of which they were respectively chairman and auditor. The only counts of the indictment which need be discussed here are the first and second which charged Lord Kylsant, under the Larceny Act, 1861, with publishing annual reports of the company for the years 1926 and 1927 'which he knew to be false in a material particular, and that the said annual reports concealed from the shareholders the true position of the company, with intent to deceive the shareholders'. Mr. Morland was charged, in similar circumstances, with aiding and abetting. It should be appreciated that the particular company was incorporated by Royal Charter and that the ordinary Companies Acts did not govern the duties of the auditor. Both the accused persons were ultimately acquitted of the charges relating to the publication of accounts. This case has been considered in Chapter VIII, to which the reader is referred.

A prosecution was brought in 1950 under Section 12 (1) of the Prevention of Fraud (Investments) Act, 1939, in connection with a prospectus issued by Richard Crittall & Co. Ltd. (*Rex v. Hinds, Musgrave and Steven*). Part of Section 12 (1) is as follows:

'Any person who, by any statement, promise or forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts, or by the reckless making of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person:

- (a) to enter into or offer to enter into: (i) any agreement for, or with a view to, acquiring, disposing of, subscribing for or underwriting securities . . . shall be guilty of an offence, and liable to penal servitude for a term not exceeding seven years.'

Two directors and the auditor were charged with inducing people to subscribe for shares in the company by recklessly making misleading statements in a prospectus. Other charges, which did not involve the auditor, were made against the two directors. The auditor was involved in connection with the auditors' report set out in the prospectus.

The count which concerned the auditor related to a sum of £99,746 which was shown under 'current assets' as 'expenditure in connection with development and expansion of export trade and newly-formed subsidiary and associated companies—carried forward'.

It was contended for the prosecution that this item, together with the profit figure for 1946, when the expenditure was incurred, was a misleading statement, and that the two directors and the auditor were guilty of making it recklessly. One of the directors (Hinds) was convicted on this charge; the other director (Musgrave) and the auditor (Mr. K. F. Steven) were acquitted. Some brief extracts from the summing-up are given in Appendix B.

It is interesting to compare Section 12 (1) of the Prevention of Fraud (Investments) Act, 1939, with Section 44 of the Companies Act, 1948. Section 44 provides that

'where a prospectus issued after the commencement of this Act includes any untrue statement, any person who authorised the issue shall be liable . . . to imprisonment . . . or a fine . . . unless he proves either that the statement was immaterial or that he had reasonable ground to believe and did, up to the time of the issue of the prospectus, believe that the statement was true'.

Subsection (2) of Section 44 provides, however, that a person shall not be deemed for the purposes of this section to have authorised the issue of a prospectus by reason only of his having given the consent required by Section 40 of the Act to the inclusion therein of a statement purporting to be made by him as an expert. Section 40 requires that a prospectus including a statement purporting to be made by an expert (including an accountant) shall not be issued unless the expert has given and has not withdrawn his consent.

Section 12 of the Prevention of Fraud (Investments) Act, 1939, contains no such reservation as that provided by subsection (2) of Section 44 of the Companies Act, 1948. One of the important aspects of the *Crittall* case is that it underlines the fact that an auditor can be made *criminally* liable for a misleading statement in a prospectus. It is, moreover, not necessary that the auditor should *know* the statement to be misleading, false or deceptive. It is sufficient if he makes such a statement recklessly.

CIVIL LIABILITY. There are two methods by which civil proceedings may be taken against auditors for damages occasioned by negligent or unskilful discharge of the duties imposed upon them—namely,

by way of action, and by way of misfeasance summons. The latter, however, only applies to auditors of companies in the course of being wound up.

It will be observed that a party bringing a civil claim does so in order to fasten on the auditor the financial responsibility for loss occasioned to the plaintiff through the failure of the auditor to perform his duty or through his negligence in the manner of performing it. The claim made is in respect of a breach of *contract*, and, hence, can be sustained only by one of the parties to that contract. The possibility of a claim being made by a third party has already been discussed in connection with the American case *Ultramares Corporation v. Touche, Niven and Co.*, and it is sufficient to say here that it is submitted that the English legal principle of privity of contract protects auditors from claims made by parties with whom they have no contract.

Damages which can be awarded follow the ordinary rule of contract, namely that the measure thereof is the loss which arises naturally and in the usual course of things from the breach (see *Hadley v. Baxendale* (1845) 9 Exch. 341). Where special damage is claimed the party alleged to be in default must have knowledge of the circumstances and must accept liability at the making of the contract. There is a duty on the party suffering the loss to mitigate the damage sustained by every means in his power.

Examples of civil liability are for damages in respect of defalcation of employees negligently overlooked and for dividends paid otherwise than out of profits owing to error or falsity in the accounts on the basis of which the dividends were declared. It should be noted, with reference to such improper dividend, that it is the company or the liquidator who can prefer a claim; but not the individual shareholders who have received the wrongful payment (see *Towers v. African Tug Co. Ltd.*). Important questions of the *dates* between which liability arises in connection with employees' defalcations will be discussed later under a special heading.

By Section 43 (1) of the Companies Act, 1948, directors, promoters, and any person who has authorised the issue of a prospectus are made liable to pay compensation to subscribers to shares or debentures who have suffered loss or damage by reason of any untrue statement in the prospectus. By Section 46 of the Act, a statement in a prospectus shall be deemed to be untrue if it is misleading in the form and context in which it is included.

An expert (including an accountant) who has given his consent to the issue of a prospectus including a statement made by him can be made liable only in respect of an untrue statement made by him. It is, however, provided by Section 43 (3) that an expert who might become liable under Section 43 (1) shall not be liable if he proves:

- (a) that, having given his consent under the said Section 40 to the issue of the prospectus, he withdrew it in writing before delivery of a copy of the prospectus for registration, or
- (b) that, after delivery of a copy of the prospectus for registration and before allotment thereunder, he, on becoming aware of the untrue statement, withdrew his consent in writing, and gave reasonable public notice of the withdrawal, and of the reason therefor; or

- (c) that he was competent to make the statement and that he had reasonable ground to believe and did up to the time of the allotment of the shares or debentures, as the case may be, believe that the statement was true.'

It will be observed that the onus of proof is placed upon the expert.

PROCEDURE BY WAY OF ACTION. One of the earliest leading cases under this procedure is the *Leeds Estate Buildings and Investment Society Ltd. v. Shepherd*, which was decided by Stirling, J., in 1887. The Headnote of the official report reads as follows:

'Held, that it was the duty of the auditor in verifying the accounts of the company, not to confine himself to verifying the arithmetical accuracy of the balance sheet, but to inquire into its special accuracy, and to ascertain if it contained the particulars specified in the articles of association and was properly drawn up to contain a true and accurate representation of the company's affairs.'

That portion of the judgment which more particularly affects auditors enforces the same doctrine in even more definite terms:

'In each of (these) years, L. (the auditor) certified that the accounts were a true copy of those shown in the books of the company. That certificate would naturally be understood to mean that the books of the company showed (taking, for example, the certificate for the year 1879) that, on the 30th April, 1879, the company was entitled to "moneys lent" to the amount of £29,515 15s. 0d. This was not in accordance with the fact; the accounts, in this respect, did not truly represent the state of the company's affairs, and it was a breach of duty upon L.'s part to certify as he did with reference to them. The payment of the dividends, directors' fees, and bonuses to the manager actually paid on those years appears to be the natural and immediate consequence of such breach of duty; and I hold L. liable for damages to the amount of the moneys so paid.'

The futility of an auditor attempting to escape his just responsibilities by a limitation of the scope of his certificate is here most forcibly demonstrated; there are, however, two other points which must not pass unnoticed.

Firstly, there was no question, in this case, as to the accounts being false. The matter in dispute was no moot question of depreciation, or of apportionment between capital and revenue; the accounts were indisputably false, and it was not even suggested that the auditor had done his best to verify their accuracy.

Secondly, the immediate result of his neglect was a payment of dividends, directors' fees, and bonus. Had no such result taken place, it is by no means so certain that any liability would have accrued.

Before dismissing this case altogether, it may be well to remark that the defendant was allowed the benefit of the Statute of Limitations; but—inasmuch as this point was not disputed by plaintiff's counsel, and was consequently not before the Court—it does not follow that a like plea would necessarily avail on another occasion, although the general view seems to be that the statute does apply in favour of auditors.

Irish Woollen Co. Ltd. v. Tyson and Others. This is another case

illustrating the possible results of negligence. It was decided by the Irish Court of Appeal, affirming the judgment of the Court below. Irish decisions are not binding precedents in England, but it is thought that the decision is sound. The circumstances may be briefly set out as under.

Dividends had been paid out of capital on the faith of accounts which were afterwards discovered to have been falsified, and the charge against the auditor may (in effect) be divided under three headings:

- (1) That he failed to discover that the stock had been overvalued.
- (2) That he failed to discover that the book debts had been overvalued.
- (3) That he failed to discover that the trade liabilities had been understated.

With regard to (1), the case appears to be on all fours with the decision in the *Kingston Cotton Mills* case, and for much the same reasons the decision of the Court was in favour of the auditor.

(2) Here, again, the Court decided in the auditor's favour, on the ground, apparently, that he could not be held responsible for the insufficiency of the amount provided against bad debts, nor for the omission to provide for cash discounts. With regard to bad debts it is quite clear that all an auditor can do is to make reasonable inquiries as to the sufficiency of the provision made, and the final responsibility must in all fairness rest with the directors and managers; but it appears to be the duty of an auditor to form a reasonable opinion as to the sufficiency of the provision, and to qualify his report if in his opinion such provision is inadequate. On the subject of cash discounts it would not have been surprising if the Court had held that a proper provision *ought* to have been made for the amount which it was expected would eventually be deducted on payment of the various accounts, although, of course, cash discounts might also properly be deducted from the trade liabilities. In this respect the decision of the Court of Appeal is perhaps more favourable to the auditor than might have been expected.

(3) It was in respect of his failure to discover that the trade liabilities were understated that the auditor was held liable for negligence. There appears to have been a systematic falsification of the books in this respect, and had this falsification been discovered at an earlier stage it would have been clear that the dividends paid had not been earned. Incidentally, the discovery of falsification in the books under this heading would naturally have aroused suspicion as to the accuracy of the records under headings (1) and (2). Without having the actual books before one it is difficult—if not impossible—to express any opinion as to whether or not a reasonably careful and skilful auditor could have discovered the frauds; but the report of the case distinctly suggests that there were points which would call for careful inquiry, and upon which in point of fact inquiry was actually made by the auditor. He appears to have noticed that certain invoices were not entered in the books until after the period to which, *prima facie*, they related, and to have inquired as to why this course was pursued. The explanation given, apparently, was that the goods relating to these invoices had not been included in stock. The explanation is by no means

unreasonable, as such a practice is certainly not contrary to the custom of many perfectly honest undertakings. In the *Kingston Cotton Mills* case it was stated that 'Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when these frauds are perpetrated by tried servants of the company, and are undetected for years by the directors'. It may well be thought that these remarks would apply equally to the *Irish Woollen Co.* case; but it may be pointed out that the practice of 'holding back' invoices because goods have not been taken into stock, although perhaps in itself permissible, is one which—considerations of fraud apart—might easily lead to mistakes. So that, if any means *are* available for checking the records of the transactions, such means ought not to be neglected by a reasonably careful auditor. It appears that the suppression of invoices would have been discovered at once, had the auditor taken the precaution of comparing the creditors' ledger balances with the statements of account forwarded by the various creditors; and, that being so, it seems reasonable to have held that he was guilty of negligence in omitting to take this precaution. It is true that the 'stock-taking' statements would only have disclosed 'suppressed' invoices, and would not have thrown any light on the invoices 'carried over'; but the discovery of a large number of invoices altogether suppressed would at once arouse suspicion in the mind of any careful auditor, and throw on him the onus of further and more exhaustive inquiry. In the 'soft goods' trade it is customary for creditors to be asked to send in 'stock-taking' statements to be compared with the creditors' ledger balances, so that, particularly in the case of a concern carrying on such a business as that of the *Irish Woollen Co. Ltd.*, it seems reasonable that the auditor should have been expected to take this precaution.

Smith v. Sheard. The report of this case (decided by Bray, J., and a special jury on 11th May, 1906) is reproduced in Appendix B, although it is feared that it will prove more confusing than instructive, inasmuch as the verdict of the jury would appear to be hopelessly wrong. The point here was whether an accountant who had (as he said, inadvertently) charged for 'auditing' accounts could be held liable for failure to detect fraud on the part of an employee, when his services as auditor had been requisitioned for another purpose, and the audit was evidently agreed for as a 'partial' audit. The moral of the case appears to be that 'partial' audits should be charged for as such, and that the precautions omitted in the process of compression should be clearly agreed to in writing, as between auditor and client. It is, however, always easy to be wise after the event. The later decision in *Fox v. Morrish Grant & Co.* still further emphasises the need for this precaution.

The decision of Alverstone, C.J., in *Henry Squire (Cash Chemist), Ltd. v. Baker & Co.* (*vide* Appendix B), is difficult to summarise; nevertheless, it contains some points of considerable importance. The plaintiff's allegation here was that the defendants had been guilty of negligence (1) in failing to detect a long-continued falsification of stock

is an end of the matter. The principal cannot expect, in the absence of special instruction, the auditor to act as a kind of deputy for the carrying out of duties, which are laid on the principal himself or on his servants. The whole key-note of the audit is "verification, not detection", and the *Scarborough* case has reaffirmed the general principle that an audit is not a roving commission to detect this, that or the other abuse which may have occurred, nor is it an indemnity to the principal against the results of his own mismanagement.'

The *Blue Band Navigation Co.* case (reported as a Canadian case, at page 853 of *The Accountant*, 16th June, 1934) is an illustration of a curious combination of facts. Negligence against the auditors was alleged in that they had passed a debt of \$37,000 in the balance sheet without comment. Originally, a current account between one Whittall (a director) and the company had fallen into debit to the extent of \$25,000; this balance was then transferred to the debit of the Western Trading Syndicate (alleged, but not proved, to be a dummy of Whittall's) together with a further sum of \$12,000 which was credited to revenue as an extraneous profit. It is not surprising that the auditors required an explanation of so unusual a transaction but this was refused by Whittall on the ground that the circumstances were 'extremely confidential'. On being pressed by the auditors Whittall assumed personal responsibility by guaranteeing the debt. At one of the general meetings the shareholders were informed by Whittall that the debt was guaranteed by him. Ultimately, the company failed to recover anything in respect of the debt.

The Court of Appeal (in Canada) absolved the auditors because, having obtained Whittall's guarantee and having no reason to suspect that it was worthless, they honestly believed the debt to be good. As the Court said: 'a Court should be sure of its grounds before substituting its own views long after the event for those of the auditors formed at the time in the light of then existing facts.' The case makes no new law, but is a useful reminder that an auditor is not a guarantor; after taking reasonable precautions by way of inquiry and weighing of the facts, he must come to an honest conclusion and report it.

The doctrine of the primary responsibility of directors for the accounts presented to shareholders received a welcome reinforcement in the case *Pendleburys Ltd. v. Ellis Green & Co.* ([1936] 80 *Acct. L.R.* 39) reported in Appendix B. The substance of the case was that three individuals were at once the only directors and the only persons with a financial interest in the company. The auditors repeatedly brought to the notice of one or more of the three directors the lack of internal check on the cash receipts but, having done this, they did not take the further step of making a formal report on the matter to the members of the company when signing the balance sheet. It was held by Swift, J., that

'there is all the world of difference between a company which has a large body of shareholders, numbering, say, six or seven hundred, and a company which has only three shareholders, all of whom happen to be the sole directors and the sole debenture-holders. The position of an auditor must be different when his duty is to vouch the information, which he gives to a large body of shareholders, as against his position when he is criticising the affairs of the company to the three men who alone are interested in the company and who hold its every pecuniary interest. In the case of a company with a large body of shareholders, he has the responsibility of watching the directors in order that those outside

people may be properly informed, for they rely upon him to keep watch on their behalf; but where the interests of a small company are confined to a very few persons and there are no outside people, because all the interests in the company are held by the directors themselves, if the auditor has, in fact, reported to the directors, what more could he be expected to do?

We have here a statement of law interpreted (as it always should be) in the light of common sense. Admittedly the protection afforded by this judgment should be relied on with great caution and, also admittedly, it would have been better had the auditors taken the precaution of making a formal report to the members; but the fact remains that men, who, as directors, take no notice of the barking of their watch-dog, cannot, as shareholders, complain of the consequences of their own neglect. One further word of warning may be added: in this case there were no outside debenture-holders and it is to be noted that the matter might have assumed a different complexion had debentures been held by third parties, because by the Companies Act, 1948, a copy of the balance sheet and annexed documents, together with a copy of the auditors' report, must be sent to every debenture-holder.

PROCEDURE BY MISFEASANCE SUMMONS. The passing of the Companies (Winding-up) Act, 1890, had a very important bearing on the liabilities of the auditors of companies. It is therefore desirable before proceeding to discuss further the liabilities of auditors, to consider the precise nature of the provisions of the 1890 Act, and the circumstances under which they apply. These are comprised in Section 10 (re-enacted as Section 276 of the Companies Act, 1929, and again re-enacted as Section 333 of the Companies Act, 1948), which is as follows:

'333.—(1) If in the course of winding up a company it appears that any person who has taken part in the formation or promotion of the company, or any past or present director, manager, or liquidator, or any officer of the company, has misapplied or retained or become liable or accountable for any money or property of the company, or been guilty of any misfeasance or breach of trust in relation to the company, the Court may, on the application of the Official Receiver, or of the liquidator, or of any creditor or contributory, examine into the conduct of the promoter, director, manager, liquidator, or officer, and compel him to repay or restore the money or property or any part thereof respectively with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance, or breach of trust, as the Court thinks just.

'(2) The provisions of this section shall have effect notwithstanding that the offence is one for which the offender may be criminally liable.'

It is thought that it may now be regarded as settled law that the duly appointed auditor of a company is one of its 'officers' within the meaning of the foregoing section.

The essential distinction between procedure by way of summons under the foregoing 'misfeasance' section and procedure by way of action is that the former can be invoked only when the company is in liquidation. It is technically a proceeding in the liquidation, and consequently, as a matter of law, all evidence available in the liquidation is evidence which can be produced in support of the summons. That is to say, that the evidence given by the respondents, either at a public

examination under Section 270 of the 1948 Act, or at a private examination under Section 268 of the 1948 Act is evidence in the misfeasance proceedings against those particular respondents, although, not against any other respondents there may be to the same summons.

This is a form of legal procedure which is new to English jurisprudence. It bears a certain analogy to the procedure of certain Continental codes, under which a person who has been accused on a criminal charge is cross-examined by an examining magistrate (who is virtually a police inspector), with a view to forwarding the case for the prosecution, and the answers given by the prisoner to such cross-examination are put in as evidence at the trial. There is, however, an automatic safeguard in the French system that does not exist in misfeasance procedure—namely, that the verdict on the facts has to be delivered by a jury, whereas the English misfeasance summons is heard before a judge alone.

It seems obvious that it must usually be difficult for any one judge (who is a lawyer, and not an accountant) to express an opinion that is really entitled to respect on the question whether or not, in a given set of circumstances, an auditor has done all that could reasonably have been required of him; and in this connection it may be added that probably no satisfactory solution of this extremely difficult problem will be arrived at until some procedure is formulated by which accountants themselves may be called in with a view to acting as assessors, if not as actual judges, on such questions. There is ample precedent for this suggestion in the Continental Court and the Admiralty Court at the present time; and it must be conceded that no commercial or marine case could possibly raise more abstruse or more technical matters than the question whether or not, in a given set of circumstances, an auditor has done his duty. For the present purpose, however, it will suffice to mention that, after some considerable experience in the Companies Winding-up Court, Vaughan Williams, J., in the misfeasance proceedings brought against the directors of the *London & Colonial Finance Corporation Ltd.*, expressed the opinion that it was far preferable for a jury—rather than any single judge—to express an opinion on the points that he was called upon to decide. It may be added in this connection that, as all the parties were not desirous of submitting their case to a jury, his lordship was compelled to hear it unaided, and eventually decided in favour of the respondents.

Having now shortly reviewed the nature of misfeasance procedure, it is time to pass on to a consideration of the effect of the decisions which have been given in the reported misfeasance summonses against auditors. All these cases will be found fully reported in Appendix B, and should be very carefully studied. The probability is that a most careful examination of the text of the various judgments will fail to deduce any satisfactory summary of the precise duty of an auditor in general circumstances; but, such as they are, they afford almost the only guide that is at present available as to the legal responsibilities of an auditor, and—unpractical as they are in many details—the auditor who desires to be on the safe side will do well to see that his audits conform as far as possible to the views there laid down.

London and General Bank case. Here it will be seen by a careful perusal of the judgments reprinted in Appendix B that, in their Lordships' view, the defendant failed, in his duty, not in neglecting any necessary portion of his investigation, but rather in failing to acquaint the shareholders with the results at which he had arrived. It appears that, in the first instance, the auditor drew up a very unfavourable report, of which he sent a copy to each of the directors; but that he was subsequently induced to modify this report, and to issue to the shareholders one that contained no reference to its existence. Thus, it appears, he was persuaded to do on the understanding that some reference would be made to the matter by the chairman at the general meeting, and because he was assured that the publication of his report would ruin the bank. At the meeting no real reference was, however, made to the auditor's report, and the auditor (who was present) allowed the omission to pass and the dividend to be voted without any protest upon his part.

The Court of Appeal held that the auditor had failed in his duty because, knowing what his report to the directors proved that he knew, he failed to place the true position before the shareholders. It was held that his certificate (to the effect that the assets were 'subject to realisation') was no true warning as to the actual position of affairs, and that the auditor had no right to depute to the chairman of the directors the duty of warning the shareholders. In paying the dividend in question the directors had committed a breach of trust, 'facilitated, and, indeed, only rendered possible by the auditor, who failed in discharging his own duty to the shareholders'. It was therefore held (following the decision in the *Leeds Building Society* case) that the auditor was jointly and severally liable with the directors to repay the amount wrongfully distributed as dividend. It may be noted in passing that Vaughan Williams' decision with regard to the dividend paid in one of the two years concerned was reversed; because, although the Lords Justices were satisfied that the accounts were incorrect, they were not satisfied that the auditor knew—or by the exercise of due diligence ought to have known—that they were incorrect, and that no profit had been earned.

The Kingston Cotton Mills case. This was a summons taken out by the Official Receiver, as liquidator of the company, applying for a declaration that the directors and auditors of the company had committed misfeasance in sanctioning the payment of dividends, on the grounds (1) that the value of the mills owned by the company, as stated in the published accounts, was greatly in excess of their actual realisable value; (2) that the value placed upon the stock-in-trade in the published accounts was greatly in excess of the actual realisable value of such stock as existed at the time. The case in the first instance came before Vaughan Williams, J., who decided on the first ground of complaint that he was bound by the previous decisions in the *Neuchatel Asphalte* case, the *Commercial and General Trust* case, and in *Wilmer v. McNamara & Co. Ltd.*, and therefore could not hold that it was necessary for a company to write down the value of its fixed assets to a figure that they might reasonably be expected to realise. With regard

to the stock-in-trade, however, he held (but was afterwards reversed) that, in point of fact, the stock sheets had been falsified by the managing director, whose certificates as to the quantities and value of such stocks had been accepted by both the directors and the auditors—the latter drawing attention to this fact in their certificate. He held that it was reasonable for the directors to accept the statement of the managing director; but that, in the circumstances of the case, it was not reasonable for the auditors to do so. He therefore held the auditors liable, but not the directors. In giving his decision, his lordship was doubtless greatly influenced by the evidence given by an examiner attached to the Official Receiver's Department of the Board of Trade, which was to the effect that a careful examination of the accounts would have shown that the percentage of gross profit disclosed by the trading accounts was so abnormal as reasonably to call for further inquiry; and a great deal might doubtless be said in favour of this view, assuming the accuracy of the facts already stated. It is no doubt the duty of an auditor to scrutinise accounts thoroughly before certifying them, and if they show on the face of them what is apparently an extraordinary state of affairs, it seems not unreasonable to suppose that the duty is cast on the auditor of inquiring further into the matter, for, although it may not be the duty of an auditor to be suspicious, it will probably be generally accepted as a statement of principle (following the words of the late Lord Davey) that 'the auditor is bound to know everything that the books tell him, to have all the suspicions that the books suggest, and to make all the inferences to which what he finds in the books would lead him'. In this case it might be held that a careful scrutiny of the accounts would have suggested suspicions, which, if once aroused, should have been thoroughly inquired into; but, against that, it must be borne in mind that Mr. Justice Vaughan Williams had before him the evidence of an examiner who had upwards of two years in which to make his investigation of the accounts, and that (combined with the fact that the investigation was made after the failure of the company) may well account for facts having then come to light which an auditor could hardly be expected to have ascertained in the ordinary course of business.

Be this as it may, however, the decision was afterwards reversed on appeal. The case for the appellants was argued before the Court of Appeal (consisting of Lindley, Lopes and Kay, L.JJ.) on the grounds (1) that the auditors had not failed to discharge their duty to the company, and were under no liability to make good the money misapplied; (2) that, even if they had, the proper remedy was by way of action and not by the summary process to which the liquidator had recourse. The Court decided to dispose of the second objection first. With regard to this, Lord Justice Lindley said that it had already been decided that the auditors of this particular company were officers within the meaning of Section 10 of the 1890 Act. The object of that section was to facilitate the recovery by the liquidator of assets of a company improperly dealt with by its promoters, directors, or other officers. The section applied to breaches of trust and misfeasances by

such persons. His lordship agreed that the section did not apply to all cases in which actions by the company might lie for the recovery of damages against the persons named; it was easy, he said, to imagine cases of breach of contract, trespasses, negligences, or other wrongs to which the section was inapplicable, and some such had been the subject of judicial decision. But he was not aware of any authority to the effect that the section did not apply to the case of an officer who had committed a breach of his duty to the company, the direct consequences of which was a misapplication of its assets, for which he could be made responsible by an action at law or in equity. Such a breach of duty, if established, was a 'misfeasance' within the meaning of Section 10, and, therefore, the procedure adopted by the Official Receiver in this case was not improper. This part of the Court of Appeal's decision is of some importance, as tending to show that, where it can be established that the auditor of a company is an 'officer of the company' within the meaning of Section 10, then any charge of negligence which can be brought against him in respect of the audit may, apparently, always be dealt with by way of misfeasance summons should the company afterwards pass into liquidation. Since the passing of the Companies Act, 1900, which made an audit compulsory, there can be little doubt that all duly appointed auditors of companies are 'officers' for the purposes of what is now Section 333 of the Companies Act, 1948.

Passing on, however, to the merits of the case, Lindley, L.J., took quite a different view from that adopted by the Court below. He pointed out that 'an auditor was not an insurer', and that in the discharge of his duty 'he was only bound to exercise a reasonable amount of care and skill'. What was a reasonable amount of care and skill in any particular case 'depended upon the circumstances of that case; and, if there was nothing which ought to excite suspicion, less care might properly be considered reasonable than would be so considered if suspicion was, or ought to have been, aroused'. In particular, his lordship 'protested against the notion that an auditor was bound to be suspicious, as distinguished from being reasonably careful'.

Lopes, L.J., said it was the duty of an auditor to bring to bear on the work he had to perform that skill and caution which a reasonably competent, careful, and cautious auditor would use. What was 'reasonable care, skill and caution' in any particular case 'must depend upon the particular circumstances of that case'. An auditor, his lordship said, 'was not bound to be a detective; or, as was said, to approach his work with suspicion, or with a foregone conclusion that there was something wrong. He was a watch-dog, but not a blood-hound, and was justified in believing tried servants of the company in whom confidence was placed by the company'. If there was anything calculated to excite suspicion, it would be his duty to probe it to the bottom, but in the absence of anything of that kind, he was bound only to be reasonably cautious and careful.

This decision has sometimes been called 'the auditor's charter'. In some respects the name is, perhaps, not unmerited; but the reader is warned that, after more than fifty years its applicability has been gradually narrowed. The broad principle remains unimpaired; but it

would, for example, be dangerous in the extreme to rely on the decision to justify cursoriness in the examination of stock sheets. This remark applies most strongly to cases where the stock is such that it is capable of reconciliation from one year to another (see e.g. *Colmer v. Merrett, Son and Street*), or where weights (e.g. of coal in the hands of a merchant) can be approximately agreed in the same way. Similarly the case would not avail an auditor who passed extravagant *valuations* of stock, nor one who ignored existing cost accounts showing the approximate amount of work in progress from time to time. The technique of accountancy and auditing has improved and developed during the past fifty years, and a standard of care and skill that would have been regarded as reasonable in 1896 may not be so regarded to-day. The requirement of the Companies Act, 1948, that the profit and loss account shall give a true and fair view of the profit or loss for the year must also be borne in mind. It can scarcely be suggested that the auditor can satisfy himself on this matter without enquiring into the stock-in-trade.

In the matter of work in progress reference should be made to the modern case *re Westminster Road Construction and Engineering Co. Ltd.* (*vide* Appendix B).

The Western Counties Steam Bakeries case. In this case the Official Receiver (as liquidator of the Western Counties Steam Bakeries Ltd.) took out a summons against Messrs. Parsons & Robjent. The preliminary objection was raised by the respondents that they were not 'officers of the company' within the meaning of Section 10, inasmuch as they had never been formally appointed auditors in accordance with the requirements of the company's articles of association; and although Vaughan Williams, J., declined to adopt this view it was the one eventually taken by the Court of Appeal, so the case was not further proceeded with. The fact that the Official Receiver did not think it worth while to proceed against the auditors by way of action, after failing to secure an order against them on a misfeasance summons shows clearly how much more unfavourable to the auditor is the latter procedure than the former.

Re Joseph Hargreaves Ltd. In this case misfeasance proceedings were taken against the auditor for having improperly sanctioned the payment of dividends out of capital. The circumstances were somewhat unusual, in that, although it was not disputed that dividends were improperly declared, it appeared that the auditor had never passed the accounts, and had systematically protested to the directors against the declaration of any dividend. No general meeting of the company had been convened, so that it was impossible for the auditor to place his views directly before the shareholders. Cozens-Hardy, J., held that the auditor had performed the whole of the duties of his position. The case is therefore of special interest, as showing that it is no part of an auditor's duty to communicate with shareholders otherwise than through the medium of the general meeting; and, further, that, even where there are such serious irregularities as the failure to convene a general meeting for several years in succession,

it is not incumbent on an auditor to resign his position and to refuse to have anything further to do with the concern.

The National Bank of Wales case (reported as *Dovey v. Cory*). This was a misfeasance summons brought against a director for having permitted the payment of certain dividends without due provision being made for bad and doubtful debts. Wright, J., held the director liable, the Court of Appeal reversed the decision, and the House of Lords confirmed the latter view. The reasons advanced by the Court of Appeal in support of its judgment attracted much comment at the time, and were stated in the fourth edition of this work to be 'somewhat extraordinary'; as, however, the case did not directly affect auditors, it was not then thought worth while to discuss the matter at great length. The decision of the House of Lords is, however, of greater importance. It upholds the judgment delivered by the Court of Appeal on 2nd August, 1899, but expressly dissents from some of the conclusions then arrived at. In this case the House of Lords has held that it is no part of the duties of a director to go into details, and that he is not responsible for the knavery or dishonesty of trusted officials of the company of which he had no knowledge at the time. The Law Lords, however, thought it desirable to express their dissent from those portions of the judgment of the Court of Appeal which declared the respondent director not liable, because they (the Court of Appeal) considered that the dividends that had been challenged had not in effect been improperly declared; and, while approving the decision of the Court of Appeal in the case of *Verner v. The General and Commercial Investment Trust Ltd.*, the House of Lords laid it down that the question as to what profits could properly be distributed by way of dividend in any individual case could only be certainly determined when that case arose for decision. It was added that, although the provisions of the Companies Act, 1877 (with regard to the reduction of a company's capital), must not be ignored, it did not necessarily follow that a company was obliged to make good the losses incurred in previous years out of subsequent profits before distributing anything by way of dividend.

This decision is of the greatest importance, as it removes the disturbing element occasioned by the judgment of the Court of Appeal, and for practical purposes replaces the whole question as to what are divisible profits upon a sound commercial basis. In the course of the judgment it was, indeed, intimated that, in deciding any particular case involving this question, the Courts would have to take into consideration the views of men of business specially versed in such transactions as those engaged in by the particular company under review.

The case *re Liverpool and Wigan Supply Association Ltd.* (vide Appendix B) is instructive as an illustration of the principle that a misfeasance summons can succeed only if it is affirmatively proved that the company sustained an actual loss by reason of the acts of which complaint is made. A rather similar limitation on the right of recovery by misfeasance summons is to be found in *re Republic of Bolivia Exploration Syndicate Ltd.*, of which the head-note is: 'Held that the auditor of a company in liquidation may be held liable for failure to

detect *ultra vires*, but only in extreme cases will the liability be enforced fully.'

As regards the magnitude of the issues involved, the decision of Mr. Justice Romer *re The City Equitable Fire Insurance Co. Ltd.* (subsequently affirmed by the Court of Appeal) is one of the most important cases affecting the liabilities of auditors that has yet been decided. This (very shortly stated) was a case in which directors and auditors had been duped, and creditors and shareholders had been defrauded, by the dishonesty of the chairman of the company, Bevan. Incidentally, Bevan was the principal partner in the firm of Ellis & Co., who acted as the company's brokers.

In a misfeasance summons brought by the Official Receiver (as the liquidator of the company), the auditors, Messrs. Langton & Lepine, were alleged, along with the directors, to have been guilty of misfeasance and breach of duty in connection with the affairs of the company as a result of which it was sought to make them liable in damages. The case, partly by reason of its inherent complexity, partly by reason of the large number of respondents, was an exceedingly lengthy one, but the main complaints against the auditors eventually resolved themselves into the following:

- (1) That they allowed certain debts due by Ellis & Co. (the company's brokers) and by Mansell (the general manager) to be included in successive balance sheets, first under the heading of 'Loans at Call or Short Notice', subsequently as 'Loans', and ultimately as 'Cash at Bank or in Hand'.
- (2) That they failed to detect certain 'window-dressing' operations, as a result of which the indebtedness of Ellis & Co. to the company at the date of certain balance sheets appeared to be very much smaller than in fact was the case.
- (3) That they failed to detect that certain of the company's securities in the hands of Ellis & Co. had in fact been pledged by them to third parties.

As a decision for the general guidance and instruction of auditors in the future, this case loses much of its significance by reason of the fact that Article 150 of the Company's articles of association was as follows:

'The directors, auditors, secretary and other officers for the time being of the company, and the trustees (if any) for the time being acting in relation to any of the affairs of the company, and every of them, and every of their heirs, executors and administrators, shall be indemnified and secured harmless out of the assets and profits of the company from and against all actions, costs, charges, losses, damages and expenses which they or any of them, their or any of their heirs, executors or administrators, shall or may incur or sustain by or by reason of any act done, concurred in or omitted in or about the execution of their duty, or supposed duty, in their respective offices or trusts, except such (if any) as they shall incur or sustain by or through their wilful neglect or default respectively, and none of them shall be answerable for the acts, receipts, neglects or defaults of the other or others of them, or for joining in any receipts for the sake of conformity, or for any bankers or other persons with whom any moneys or effects belonging to the company shall or may be lodged or deposited for safe custody, or for insufficiency or deficiency of any security upon which any moneys of or belonging to the company shall be placed out or invested, or for any other loss,

misfortune or damage, which may happen in the execution of their respective duties or trusts, or in relation thereto, unless the same shall happen by or through their own wilful neglect or default respectively.'

In view of the far-reaching terms of this article, it is clear that, in order to establish liability on the part of the auditors, it was necessary not merely to prove that they had failed to bring to the discharge of their duty such care and skill as a reasonably careful and skilful auditor would bring, but also to show that any proved failure of duty on their part was *the result of their own wilful default and neglect*. This aspect of the matter is very fully dealt with by all the Appeal judges in their respective judgments. At the time when the case was heard an article such as this was held not to be *ultra vires*, on the somewhat slender ground that as the duties of an auditor were not defined by statute *in extenso* it was not contrary to statute to introduce into the contract for the employment of an auditor in any particular case special conditions as to what the duties of that auditor should be.

Section 152 of the Companies Act, 1929 (now Section 205 of the Companies Act, 1948), largely as a result of the *City Equitable* case, has now made void 'any provision, whether contained in the articles of a company or in any contract with a company or otherwise, for exempting . . . any person (whether an officer of the company or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company'. Hence the case might have been decided very differently had it occurred after the passing of the 1929 Act.

For these reasons, it is not difficult to exaggerate the importance of Mr. Justice Romer's decision. Nevertheless it is desirable that the effect of that decision should be considered with all due care. Apparently, his lordship saw no impropriety in a debt due to a company by its brokers being described as 'Loans at Call or Short Notice', or even as 'Cash at Bank and in Hand', so long as he was satisfied that it would have made no practical difference to anybody had it been more precisely described. City men will probably agree that the term 'Loans at Call or Short Notice' is invariably assumed to imply loans on those terms to a bank or an accepting house; and it may be added, it is thought without any fear of contradiction, that the term 'Cash in Hand', as used in business circles, means something very much more than a debt legally due and enforceable. The term 'Cash at Bankers', is, it is quite true, loosely used, as representing merely a credit balance at a bank on current account—a debt payable by a banker on demand—but the term 'Cash in Hand' in the ordinary balance sheet can, it is suggested, properly be applied only to a sum of money actually in existence, and capable of verification in the hands of a custodian in the employment of the concern.

In this connection it may be recalled that one of the counts on which certain directors and the auditors of *Dumbell's Banking Co. Ltd.* were convicted, charged them with being concerned with the issue of a false balance sheet with intent to defraud, because *inter alia* a credit of

£65,000 obtained from the London City and Midland Bank Ltd., was included in the balance sheet under the item 'Cash in hand'.

Where, as in the *City Equitable* case, the directors have passed a resolution, limiting a particular loan to £15,000, and it subsequently creeps up to nearly £100,000, and the auditor notices what is happening, and discusses the matter with the chairman who promises to report it to the board, but does not do so, it is submitted that a state of affairs arises somewhat similar to that obtaining in the *London and General Bank Ltd.* case, when the late Lord (then Mr.) Justice Vaughan Williams held that an auditor who reported to the board what he ought to have reported to the shareholders was guilty of misfeasance; and this opinion is held notwithstanding the dictum of Lindley, L.J., in the same case, that 'it is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security'. Further, it is submitted that a balance sheet is not properly drawn up to disclose the financial position of a company, if ordinary loans—whether good, bad or doubtful—are described as 'Cash in Hand'.

Passing on to the second point, the 'window-dressing' operation, which resulted in £200,000 Treasury Bills appearing as an asset in the balance sheet on 28th February, 1919, and £390,000 Treasury Bills in the balance sheet for the following year (the indebtedness of Ellis & Co. being in each year correspondingly reduced), when in truth, according to his lordship's judgment, 'the company never had such an investment', there can be little doubt that operations of this kind are often impossible of detection, if, at the time of the audit, the auditor sees nothing of the entries relating to the transactions subsequent to the date of the balance sheet. There does not appear to be any judicial dictum hinting that it may ever be necessary for an auditor, in the due discharge of his duties, to examine the record of transactions up to the actual date of the audit; but, notwithstanding, the experienced auditor will know very well that it is often quite impossible for him to make what he would consider to be a satisfactory audit in any other way. In the nature of things, the assets on the date of a balance sheet are often in many very material respects different from the assets in existence at the subsequent date of the actual audit: any physical inspection of what is no longer in existence is manifestly impossible. There are, accordingly, only two possible alternatives in practice: (a) to audit the transactions up to the then present date, and examine the assets then in existence; or (b) to accept the certificates of independent and responsible parties as to what was in existence on the date of the balance sheet.

Coming to the third heading, Mr. Justice Romer expressed considerable doubt as to whether an auditor ought to be satisfied with the certificates of independent parties in any circumstances, although he refrains from laying down any definite rule on the point. But the practical auditor can hardly fail to recognise a distinction between accepting a certificate from a bank, or even a safe deposit company, and accepting the certificate of (say) the brokers or solicitors of the

company, with whom *prima facie* any deposit of documents for an extended period is irregular. In this particular case, of course, the certificate of the brokers should, it is submitted, have been regarded with more than usual hesitation by reason of the fact that the chairman of the company was the head of that firm, and accordingly the brokers' certificates amounted to little more in practice than a certificate of the chairman himself.

To sum up, there seems no doubt (*if Article 150 be valid*) as to the correctness of Mr. Justice Romer's decision that, in view of all the circumstances, the proceedings against the auditors must be dismissed with costs. It is suggested, however, that there was nothing brought to light in this case that indicates the impracticability of devising a scheme of audit which will at an early date detect dishonesty on the part of the chairman of a company, so long, of course, as the auditor is not content to rely overmuch on the dictum laid down in *The Kingston Cotton Mills* case, that an auditor is justified in relying on statements made by tried servants of the company in whom confidence is placed by the company. For some purposes, very obviously the auditor is obliged to rely on statements made to him by others, but it is not right or reasonable that he should rely on the statements of others in connection with matters that it is quite practicable for him to verify by personal investigation.

The decision of the Court of Appeal, unanimously upholding Mr Justice Romer's judgment, should be read with the utmost care. Each of the three distinguished judges approaches the matter from a slightly different angle, and all arrive at the same conclusion. The effect was, of course, to make it, if possible, clearer than it was before, that there could be no such thing as real auditorial responsibility so long as the principle of 'contracting out' by special articles of association was permitted, and, as already stated, the 1929 Act effected the disappearance of such clauses, thereby undoubtedly restoring public confidence in the efficiency of an audit. The auditors in this particular case had, of course, extraordinary difficulties to contend with; but so, for that matter, had the auditors of the London and General Bank Ltd. In each case it seems that the crux is not so much what ought a reasonably careful and skilful auditor to have discovered, but, rather, to whom ought such an auditor to have reported what he admittedly did discover.

The final case to be reviewed under the heading 'misfeasance' is one which may well give auditors pause for thought. In *re Westminster Road Construction and Engineering Co. Ltd.* (*vide* Appendix B) the auditor was held liable for a wrongful payment of dividend based on accounts passed by him. The report shows how easy it is for the responsibility for figures for work in progress to slide off the shoulders of directors and officials of the company, finally to rest on the shoulders of the auditor. In the particular case there were undisclosed liabilities for sub-contracting and for contractor's reinstatement work. Mr. Justice Bennett said of auditors in general: 'Their duty with regard to the ascertainment of unrecorded liabilities must depend upon the facts of each particular case and must be determined by the nature of

the business carried on and the practice of the persons or bodies, with whom the company did business, of sending in their invoices' and his lordship went on to point the moral that specific inquiries should be made where a company in the course of its business incurs liabilities of a particular kind. The case represents, it is submitted, a considerable whittling down of the *Kingston Cotton Mills* principle. It is worthy of note that the directors were absolved from the parallel claims made against them.

AUDITOR'S LIABILITY FOR DEFALCATIONS OF EMPLOYEES. The liability of auditors to their clients for defalcations committed by employees is very real and an ever-present source of danger. The reports in *Wilde v. Cape & Dalgleish*, and *Martin v. Isitt* (*vide* Appendix B), may advantageously be consulted in this connection as may the cases of *London Oil Storage Co. Ltd. v. Seear, Hasluck & Co.* (*vide* Appendix B), *Charles Fox & Son v. Morrish Grant & Co.* ([1918] 59 *Acct.*, L.R. 29) and *The Trustee of the property of Apfel (a bankrupt) v. Annan, Dexter & Co.* (*vide* Appendix B). A more recent case is *re S. P. Catterson & Sons Ltd.* (81 *Acct.*, L.R. 63). The auditor will be liable to be proceeded against by way of action for negligence in the discharge of his duties; and, if it can be shown that the defalcations have resulted from the negligence or incapacity of the auditor, he will be held liable in damages accordingly. In *Martin v. Isitt*, the plaintiffs claimed damages by reason of the fact that the monthly audit, which the defendants had contracted to perform, had been allowed to fall into arrear, and that the defalcations had remained undetected for a longer period than, in the plaintiff's view, was reasonable. The case was eventually settled without any definite expression of opinion on the part of the judge as to its merits; but doubtless, in so far as the delay in the monthly audit was unreasonable, the auditor would be responsible for any loss incurred by his clients in consequence. The question is obviously, therefore, one of the very greatest importance, as showing the extreme desirability of monthly (and other periodical) audits being punctually proceeded with. On the other hand, a reasonable margin would, no doubt, be allowed in all cases. It would be manifestly impossible for an auditor to commence his investigations in all cases *immediately* after the period had elapsed, and consequently it is only reasonable to suppose that some 'give and take' would be employed in applying the general rule; otherwise the position of professional auditors, say, in the month of January, would be a serious one.

There are very important dicta in the case of the *London Oil Storage Co. Ltd. v. Seear, Hasluck & Co.* (*vide* Appendix B), which came before Lord Alverstone, C.J., and a special jury in 1904. To the casual onlooker this case would appear to be quite straightforward, but Lord Alverstone devoted so much care to his summing-up that it seems clear the matter struck him as being one of more importance and more difficulty than appears to the ordinary observer. The principles governing the matter were, he said, clear, but the practical application of those principles to any individual case was a matter of

the very greatest difficulty. This admission is to be welcomed, as affording a most acceptable contrast to the manner in which the Courts regarded the views of auditors a dozen years before; but if the situation in the case referred to was so difficult as seriously to tax the intelligence of a special jury, it is clear that the present author was by no means overstating the case when—in the fourth edition of this work—he expressed the view that such important and highly technical matters ought not, in fairness to auditors, ever to be decided by a single judge. Shortly stated, the points at issue here were as follows: During a number of years the defendants had taken no steps to verify the amount of cash in hand appearing on the balance sheet. During those years the amount of this balance had very materially increased, and during the latter part of the period had not been shown separately from the balance at bank. Eventually, owing to the illness of the responsible cashier, it was discovered that the bulk of this balance was non-existent, with the result that the company sustained a loss of some hundreds of pounds. On behalf of the defence it was argued (1) that in the absence of suspicious circumstances an auditor was entitled to rely upon the statements of trusted employees (*vide Kingston Cotton Mills* case); (2) that there were no suspicious circumstances here; (3) that the directors had not had their suspicions aroused, and, therefore, if the case was one for suspicion, they were at least equally negligent; (4) that there was no evidence to show that the whole of the deficiency in the cash balance did not occur since the date of the last audit, in which case clearly the auditor could not be responsible. The jury found that during the last four years the auditor had committed a breach of his duty, and they assessed the damage sustained owing to this breach of duty at five guineas, adding as a rider that they considered the directors had been guilty of gross negligence. On the whole this verdict cannot be said to err on the side of severity. It is thought, however, that the defendants made their case worse by adopting too low a view of auditorial responsibility. There are, of course, many things that an auditor *must* from time to time take on trust; but in normal circumstances balance of cash in hand seems to be the one asset in a balance sheet that is capable of absolute and unconditional verification. In the absence, therefore, of very exceptional circumstances—as, for example, in the case of an undertaking having numerous branches—the cash in hand should invariably be verified by the auditor. The actual counting of the balance of cash in hand at each of several branches may not be practicable, but, so far as can be gathered, no such difficulty arose here; while the very considerable increase of cash in hand (an increase in no way connected with the actual requirements of the business) ought, it is thought, in all cases to be regarded by the careful auditor as a matter calling for careful inquiry, if not actually a matter for suspicion. That the directors showed negligence in allowing such a large balance to accumulate in the hands of one of the employees of the company goes, of course, without saying; but it would be straining the decision of the Court of Appeal in the *Kingston Cotton Mills* case too far to suggest that, however, negligent the directors of a company may be, so long as *they* are satisfied the auditor need inquire no further. If that

really represents the true limit of an auditor's duties, those duties might be regarded as adequately discharged if the auditor did nothing more than require the directors to sign the draft balance sheet before he did so himself! It is obviously in the interests of professional auditors that their duties should not be made unduly onerous, and that they should not be held responsible for the absolute accuracy of statements contained in the accounts which it is impossible for them to verify; but it is thought that it is equally in the interests of the profession that, within such limits as may be practicable, the full responsibility of auditors for the performance of their duties with reasonable care and reasonable skill should be rigidly enforced.

Rex v. Oliphant and *Rex v. Solomons* (*vide* Appendix B) furnish useful illustrations of the kind of evidence on which defaulting employees can be convicted; while *Calne Gas Co. v. Curtis* is an instance where the auditor escaped liability notwithstanding that the existence of a defalcation was admitted.

The case *Armitage v. Brewer and Knott* which was decided by Talbot, J., in December, 1932 (*vide* Appendix B), merits special notice by reason of certain dicta of the judge which, it is submitted, ought not to pass without respectful protest. His lordship is reported to have declared 'it was the duty of auditors to be suspicious, that was what they were there for'. Readers of this work do not need to be reminded that there is very high authority for stating the very reverse. In another place the judge said that 'one of the objects of an auditor was to enable the employer to get rid of a fraudulent servant, and the natural result if one left a fraudulent book-keeper was that frauds would follow'. This statement may sound harmless at first reading but in fact it was used to counter a point urged by counsel for the defence with reference to remoteness of damage, with the result that undetected petty cash losses of only £69 led to damages £1,259, mostly in respect of time sheets which only later came into the case. To quote the judgment, 'His lordship was satisfied that if the defendants had done their duty before the time sheets came into the case, Miss Harwood would have gone and there would have been an end of all frauds'.

The question thereby raised, and which must now be dealt with is--at what point do damages in defalcation cases become too remote, and, in particular, may an auditor who fails to detect an irregularity in a particular audit period become liable for a fraud committed in a subsequent period *before he has an opportunity of resuming the audit*. On this most important point the authority of *The Accountant* may be invoked. In an article published on 4th February, 1933, referring to the *Armitage v. Brewer and Knott* case the following passages occurred.

'As we have said, however, the case gives a footing disadvantageous to the profession for applying the principle of consequential damage to audit claims, and one of our correspondents has pointedly stated a case of pure consequential damage, which merits careful consideration. Thus, if an auditor omits to detect a defalcation by an employee and in the following year, before there is the chance of any further audit, the employee, emboldened by having escaped detection, embezzles a larger sum, is the auditor liable both for the original embezzlement which he failed to detect and for the subsequent loss to the employer as well?

'So far as we are aware, there is no exact professional precedent. Needless to say, we do not want to see one. The general rule, of course, is that a plaintiff

will only be awarded such damage as flows in natural sequence from the defendant's neglect. There is a corollary to that rule, which may have a bearing on the problem, and may be stated thus: One person may be negligent and by the negligent or wilful act of another, the negligent act of the first may cause injury to a third. Then a distinction is to be made. If the first negligent act is not in its nature such that the second might be looked for as a natural and probable consequence, then the first negligent person is not responsible. If the subsequent negligence is likely to follow from the antecedent negligence, then the first negligent person is liable and the question must be left to the jury whether the first wrong-doer's act was the proximate cause of the plaintiff's injury.

Addressing ourselves then with such help as we can get to the question set to us, the answer to our mind depends on the character of the initial error or omission. A mere mistake will not render a professional man liable for its consequences, but if the negligence was of the same type as was alleged in the case under discussion, i.e. omitting to detect a fraud which by the exercise of reasonable care an accountant would have detected, then we are inclined to think that a jury would take into account the consequential loss in their award of damages. On the other hand, if the auditor's failure to detect defalcation was not blameworthy, and if his professional brethren appeared in his support, and stated that he could not reasonably be expected to detect such a defalcation, then he might not, in our opinion, be liable. We agree that this is tantamount to giving an affirmative answer to the question whether an auditor may be liable for consequential loss; and as stated we have little or no authority to guide us; but we leave the question there meantime and shall be glad to receive any further observations which our readers may feel inclined to communicate to us.

The case *re S. P. Catterson & Sons Ltd.* (81 *Acct.*, L.R. 62), reported in full in Appendix B, was an attempt by a liquidator under Section 276 of the Companies Act, 1929 (now Section 333 of the Companies Act, 1948), to make an auditor responsible for certain defalcations which occurred in peculiar circumstances. Its result is a wholesome reminder that, in the words of the trial judge, 'the primary responsibility for the accounts of a company is with those who are in control of the company, that is to say, the directors'.

Briefly, the company's accounting system provided that cash sales should be recorded on dockets of which the top copy was handed to the customer, a carbon copy remaining in the 'invoice book'. From these counterfoils, entries were made in a daily cash sales book where the serial numbers were recorded, and the total cash was then handed to a director of the company. In course of time the practice grew up of entering in this 'invoice book' items which were sales, not for cash, but on short credit, and the relative counterfoils were 'dog-eared' as an explanation of their absence from the daily cash total. This variation gave an obvious opportunity for fraud and ultimately a dishonest employee took advantage of the situation. The evidence was that the auditor drew the attention of the directors to the unsatisfactory aspects of the system and recommended improvements, but his advice was disregarded. Commenting on the claim made against the auditor in these circumstances, the judge said:

'It is clear that the unsatisfactory system employed in the showrooms was clear to the mind of the auditor, and that it was called by him to the attention of the directors and that notwithstanding that fact they preferred, for some reason or another, to continue the system as it was. I am not prepared to hold in those circumstances and on those facts that there was any duty upon the auditors to insist upon that system being changed. It is not their business to tell directors how to carry on and conduct their accounting system; they make their recommendations and, if they are not acceded to, the responsibility is not the auditor's responsibility but it is the responsibility of the directors.'

CHAPTER XIII

INVESTIGATIONS

AN investigation is an examination of accounting records undertaken for a special purpose; in effect it is an audit of which the scope is limited or extended in accordance with the requirements of the particular purpose. Its object is usually to discover and display the facts in such a manner as will enable the parties for whom it is undertaken to draw conclusions and make their decisions accordingly.

The reader will understand that the subject lies on the borderline between accounting and auditing. It is difficult to treat systematically because the cases which arise in practice are so various; in fact most members of the profession will agree that investigation work adds the spice of variety which makes the life of an accountant so attractive to men of active and inquiring mental temperament. Let it be said at once that the work demands the most expert and thorough training in accounting principle combined with long practical experience and, while in every case routine must be most carefully observed, the investigator needs that open-eyed quality which alone will enable him to distinguish the signs which he can use as finger-posts pointing him to his ultimate goal. Further, the accounting work having been finished, the principal in charge of the investigation must possess the power to sum up the conclusions he has drawn in a report couched in vivid, but sober, language, so that the clients may receive a clear impression neither lacking in force through undue compression nor diluted with diffuse and unnecessary detail. The reputations which have been made in the accounting profession by brilliant pieces of investigation work suggest that of the investigator, as of the poet, it may be true to say *nascitur non fit*.

STEPS PRIOR TO COMMENCING WORK. One of the peculiar features of an investigation is that its success or failure is often determined by an appreciation, *before the work is commenced*, of the objects to be achieved. Only if this truth be held in mind is it possible to direct the work along the most useful channels. It is essential therefore that at the earliest point the whole matter be thoroughly discussed with the clients with a preliminary view to ascertaining that they are clear about *their* requirements. The possibility of giving them the benefit of training and experience in this field is obvious. When the accountant has clearly fixed his object he can begin to work out in his mind the course by which it may be reached.

It is next necessary to discover for whose benefit the results obtained are to be used. This is most important because, obviously, a report is coloured by the viewpoint taken. A vendor, for instance, desires to be advised how he may obtain the most favourable price, while a purchaser requires to be safeguarded against unwise expenditure of money. On the other hand a document such as the prospectus of a

public company must comply with certain statutory requirements and in any event a report intended to form the basis of an arrangement between vendor and purchaser must studiously observe the interest of *both* parties.

The investigator must next make up his mind (*a*) how far back his investigation is to be carried and (*b*) what material he may accept as correct. The period to be covered must be determined by the circumstances of each case and (often) by considerations of expense. It need hardly be stated that the later end of the period should be as recent as possible. In connection with the acceptance of material it is always relevant to inquire for what purpose it was originally prepared. If, for example, an investigator is acting for a proposed purchaser and is presented with a set of accounts prepared for the purpose of the negotiations by the vendor the investigator is on his guard at once; but, on the other hand, accounts prepared for ordinary purposes and audited by a reputable auditor may usually be accepted as arithmetically correct subject to analysis of the figures in the light of the desired purpose.

It is hardly necessary to add that those relying on the accountant's report will naturally, and indeed reasonably, take it for granted that so long as they adequately explain their object in seeking his assistance, it is for him, as an expert, to decide both the nature and the extent of the examination itself. And, if it is subsequently discovered that an investigation had failed to achieve its intended object, it would be for the accountant to show that the failure did not arise from any cause which could have been prevented by a more complete, or a more exhaustive examination. There can be no doubt that whatever instructions the accountant may have received were intended rather as a description of the object to be effected than as a definite requirement as to the means by which that object was to be attained. It goes without saying that the best authority as to the means to be employed must be the accountant himself (who receives his instructions by virtue of his being an expert in the matters requiring investigation), and it is clear that—however desirable it may be that he should receive, and even welcome, suggestions as to the *modus operandi* of his work—an accountant cannot submit his professional discretion to the dictation of his clients without sacrifice of self-respect and grave danger to his clients' interests.

The position of the investigating accountant, when only incomplete sets of books are available, is a question of very considerable importance. So long as the books are sufficiently complete to enable the accountant reasonably to arrive at the conclusion that (so far as they go) they are accurate, there can, it is thought, be no objection to his issuing a report confined to such matters as the books may show. But there is a danger of the whole system of investigation falling into discredit, if accountants go too far, and substitute for certificates of actually accomplished facts statements so qualified as to amount, in effect, to little more than a carefully safeguarded expression of speculative opinion. Unless, therefore, an accountant has really something to *certify* he should studiously refrain from issuing any statement of opinion, or

estimate, in the form of a certificate. Further, of course, the principle that no prophecy is ever to be made about the future is especially to be emphasised in investigation work.

OBJECTS OF INVESTIGATIONS. The particular purposes for which investigations are usually made may be classified as under:

I. ON THE SALE OF AN UNDERTAKING:

- (a) To a proposed public company.
- (b) To a private purchaser.

II. ON AN ALTERATION IN THE FINANCIAL CONSTITUTION OF AN UNDERTAKING:

- (a) Where a company reconstructs.
- (b) Where companies amalgamate.
- (c) On changes in partnership.

III. FOR THE PURPOSE OF OBTAINING SPECIAL INFORMATION :

- (a) On behalf of a present or prospective creditor.
- (b) In connection with suspected fraud.
- (c) In connection with taxation liabilities.
- (d) In connection with share transfers.

These matters may be considered *seriatim*. It is hardly necessary to say that the scope of this chapter comprehends only those matters which are peculiar to an investigation as such; nevertheless all engagements will include work which does not differ from that of pure auditing.

1. (a) INVESTIGATION FOR PROSPECTUS OF PROPOSED COMPANY

It will be convenient also to consider under this head the investigation necessitated by the issue (through the medium of a prospectus) of new share or debenture capital.

Here the very first matter engaging attention is Section 38 of the Companies Act, 1948, which requires that 'every prospectus issued by or on behalf of a company . . . must state the matters specified in Part I of the Fourth Schedule to this Act and set out the reports specified in Part II of that Schedule, and the said Parts I and II shall have effect subject to the provisions contained in Part III of the said Schedule.'

Part II of the Fourth Schedule is as follows:

PART II

REPORTS TO BE SET OUT

19. (1) A report by the auditors of the company with respect to—
- (a) profits and losses and assets and liabilities, in accordance with subparagraph (2) or (3) of this paragraph, as the case requires; and
 - (b) the rates of the dividends, if any, paid by the company in respect of each class of shares in the company in respect of each of the five financial years immediately preceding the issue of the prospectus, giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years;

and, if no accounts have been made up in respect of any part of the period of five years ending on a date three months before the issue of the prospectus, containing a statement of that fact.

(2) If the company has no subsidiaries, the report shall—

(a) so far as regards profits and losses, deal with the profits or losses of the company in respect of each of the five financial years immediately preceding the issue of the prospectus; and

(b) so far as regards assets and liabilities, deal with the assets and liabilities of the company at the last date to which the accounts of the company were made up.

(3) If the company has subsidiaries, the report shall—

(a) so far as regards profits and losses, deal separately with the company's profits or losses as provided by the last foregoing sub-paragraph, and in addition, deal either

(i) as a whole with the combined profits or losses of its subsidiaries, so far as they concern members of the company; or

(ii) individually with the profits or losses of each subsidiary, so far as they concern members of the company; or

instead of dealing separately with the company's profits or losses, deal as a whole with the profits or losses of the company and, so far as they concern members of the company, with the combined profits or losses of its subsidiaries; and

(b) so far as regards assets and liabilities, deal separately with the company's assets and liabilities as provided by the last foregoing sub-paragraph and, in addition, deal either

(i) as a whole with the combined assets and liabilities of its subsidiaries, with or without the company's assets and liabilities; or

(ii) individually with the assets and liabilities of each subsidiary;

and shall indicate as respects the assets and liabilities of the subsidiaries the allowance to be made for persons other than members of the company.

20. If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of any business, a report made by accountants (who shall be named in the prospectus) upon—

(a) the profits or losses of the business in respect of each of the five financial years immediately preceding the issue of the prospectus; and

(b) the assets and liabilities of the business at the last date to which the accounts of the business were made up.

21.—(1) If—

(a) the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in any manner resulting in the acquisition by the company of shares in any other body corporate; and

(b) by reason of that acquisition or anything to be done in consequence thereof or in connection therewith that body corporate will become a subsidiary of the company;

a report made by accountants (who shall be named in the prospectus) upon—

(i) the profits or losses of the other body corporate in respect of each of the five financial years immediately preceding the issue of the prospectus; and

(ii) the assets and liabilities of the other body corporate at the last date to which the accounts of the body corporate were made up.

(2) the said report shall—

(a) indicate how the profits and losses of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company and what allowances would have fallen to be made, in relation to assets and liabilities so dealt with, for holders of other shares, if the company had at all material times held the shares to be acquired; and

(b) where the other body corporate has subsidiaries, deal with the profits or losses and the assets and liabilities of the body corporate and its subsidiaries in the manner provided by sub-paragraph (3) of paragraph 19 of this Schedule in relation to the company and its subsidiaries.

By Section 30, when a private company becomes a public company, it must file with the Registrar of Companies a statement in lieu of prospectus. If unissued shares or debentures of such a company are to be applied in the purchase of a business or in the acquisition of shares in a body corporate which as a result becomes a subsidiary, the statement in lieu of prospectus must include reports by accountants regarding the profits and losses and assets and liabilities of the business or body corporate. Section 48 provides that a public company which does not issue a prospectus, or does not allow any of the shares offered in a prospectus, shall not allot any shares or debentures unless at least three days before allotment it registers a statement in lieu of prospectus. Where it is proposed to acquire a business or shares in a body corporate which as a result becomes a subsidiary the statement must include reports by accountants regarding the profits and losses and assets and liabilities of the business or body corporate. In both cases, the reports to be included in the statement in lieu of prospectus (whether registered under Section 30 or Section 48) are the same as those required, in the case of a prospectus, by paragraphs 20 and 21 of the Fourth Schedule.

In the case of a company which has been carrying on business or of a business which has been carried on for less than five years, the reports required by Part II of the Fourth Schedule are to deal with such shorter periods as are appropriate to the case. This necessary modification applies also to a statement in lieu of prospectus.

The reports of auditors or accountants must not deal with average profits only; the figures for each year must be stated. In practice the reports usually cover a period of ten years, so as to comply with Stock Exchange regulations.

The accountants who make the reports required by Part II of the Fourth Schedule must be qualified for appointment as auditors of a company other than an exempt private company. An accountant who makes any such report must not be an officer or servant of the company or of any other company which is a member of the same group, i.e. which is its holding company, subsidiary or fellow-subsidary. It is also provided that he must not be a partner of or in the employment of such an officer or servant.

It is provided by Section 40 that a prospectus including a statement purporting to be made by an expert shall not be issued unless he has given and has not withdrawn his consent to the issue of the prospectus with the statement included in the form and context in which it is included. A statement that the expert has given and has not withdrawn his consent must appear in the prospectus. For purposes of this Section, 'expert' includes an accountant.

ADJUSTMENTS IN PROFITS. Paragraph 29 of the Fourth Schedule provides as follows:

Any report required by Part II of this Schedule shall either indicate by way of note any adjustments as respects the figures of any profits or losses or assets and liabilities dealt with by the report which appear to the persons making the report necessary or shall make those adjustments and indicate that adjustments have been made.

This requirement applies also to a statement in lieu of prospectus.

If the persons making the report have made adjustments or have indicated adjustments, a written statement signed by those persons setting out the adjustments and giving reasons must be endorsed on or attached to the copy of the prospectus delivered for registration, or to the statement in lieu of prospectus, as the case may be.

It must not be forgotten that investors are interested primarily in the future prospects of the company. The object of making adjustments to the figures of past profits and losses is to enable intending shareholders to judge what profits are likely to be under the new conditions. Unless certain adjustments are made or indicated, past results may frequently be unreliable and misleading, considered as a basis on which to found estimates of future results.

Among the matters requiring adjustment, one of the most important is the treatment of fixed assets and their depreciation. Under present conditions, the current value of fixed assets may be substantially higher than the amount at which the assets appear in the books, and replacement cost is usually much greater than the original cost of the existing assets.

The depreciation and valuation of fixed assets in relation to reports for prospectus purposes is the subject of Recommendation No. XIII of the Recommendations on Accounting Principles issued by the Institute of Chartered Accountants. (*vide* Appendix C).

It is recommended, in the first place, that, if material to the presentation of the figures, the amounts charged for depreciation in the years under review should be stated in the report.

If fixed assets have been written up by reference to a current valuation, and there has been a change in the basis of depreciation during the period covered by the report, it is recommended that the effect of the change should be indicated in the report if the effect is material and cannot be dealt with appropriately in arriving at the figures shown in the report. If the assets have been written up after the period covered by the report, future depreciation will be charged at a higher rate than during the period covered by the report. It is remarked in the Recommendations that it is not normally appropriate or practicable to make consequential adjustments in the depreciation provisions for past years; it is recommended that the report should indicate the approximate future annual provision computed on the basis of the valuation and should give a comparison thereof with the actual provision made in arriving at the profit or loss shown in the report for the last year covered thereby.

If the valuation of the fixed assets is used for prospectus purposes only and is not incorporated in the books, subsequent depreciation provisions will not be adequate to maintain the capital of the undertaking, and, if the capital is to be maintained, it is necessary to set aside out of profits additional amounts for enhanced replacement cost. It is recommended that where a valuation of fixed assets is used by the directors in the prospectus in order to indicate the assets cover for the issue, but the valuation is not adopted for the purposes of the books and accounts, the report should not include figures

based on, or a reference to, a valuation in excess of the amounts standing in the books. It is also recommended that, before consenting (under Section 40 of the Act) to the inclusion of their report in the prospectus, the accountants should either—

- (i) ascertain from the directors that the directors' estimates of future profits available for dividend, as shown in the prospectus, have been arrived at after appropriate deductions have been made for the profits which it will be necessary to retain as reserves (including profits set aside for the redemption of preference shares or debentures) in order to maintain the assets cover indicated in the prospectus; or
- (ii) if such deductions have not been made, satisfy themselves that the disclosure is sufficient to show how far the directors have taken this factor into account.

Allowances for taxation in respect of fixed assets may be substantially less than the depreciation charged in the accounts. For certain fixed assets, there may be no allowance for taxation purposes; if fixed assets have been written up on a revaluation, the subsequent depreciation charges in the accounts will be in excess of the allowances for taxation, based on actual cost; in other cases, the price paid for fixed assets on the acquisition of a business may be greater than the amount on which allowances for taxation purposes are available to the purchaser. If for these or other reasons, the amounts chargeable in future for depreciation are materially in excess of the allowances obtainable for taxation purposes, it is recommended that:

- (a) the report should indicate the extent of the excess of the depreciation chargeable over the taxation allowances obtainable for the year immediately subsequent to the period covered by the report; and
- (b) the report should also indicate that owing to the disallowance for taxation purposes of this excess, the sum required to cover it is the gross amount which after deduction of income-tax and profits tax will leave a net amount equal to the excess.

Apart from depreciation of fixed assets, certain other adjustments may be thought necessary.

It is usual to add to the 'book' profits all items falling within the following classes:

- (a) Income-tax Schedule D, sur-tax, profits tax, interest on partners' capital, partners' salaries, except in so far as these represent a reasonable rate of remuneration for services rendered to the business.
- (b) Interest on such debts and advances as will be paid off out of the new capital to be subscribed. Discounts lost through shortage of working capital (this item obviously requires care).
- (c) Losses arising from causes clearly outside the normal scope of the business, such as losses (not covered by insurance) through fire, accidents to employees, or defalcations; provided a sufficient charge against profits is made to cover the amount which such insurance would have cost. Losses arising through actions at law not altogether incidental to the carrying on of the business,

as, for instance, through breach of contract, infringements of patent, &c.; but, if the losses arising from these causes are excluded, it is essential that whatever profits may have been earned in connection with the subject-matter of the action should also be excluded, unless the litigation resulted in favour of the proprietors of the business being investigated.

- (d) Losses on sale of fixed assets or permanent investments.
- (e) Additions to capital assets which have been charged against revenue.
- (f) Rent paid for premises to be purchased by the new company.

On the other hand items as under should be deducted from 'book' profits:

- (a) Exceptional profits arising from such transactions as it is not reasonable in the ordinary course of events to anticipate will frequently *recur* in the carrying on of the existing business on ordinary lines. It is naturally impossible to deal exhaustively with this class of item, but the following headings may be mentioned:
 - (i) any profit received from a local authority by way of compensation for compulsory removal of the business premises;
 - (ii) any profit received from an insurance company in respect of a risk covered by a policy of insurance;
 - (iii) any profit received in connection with the sale of a portion of the undertaking, as, for instance, the sale of a patent, or of certain limited rights to work a patent, or of any fixed assets that may have been acquired for the purpose of working any portion of the concern in question.
- (b) A fair sum representing salary which would have been paid to an employee to perform services actually rendered by a partner or proprietor for whom no salary has been charged.
- (c) A fair sum representing rent where the vendor owns the premises and these are not being acquired by the purchaser.

Generally in matters of this description there is always a temptation to emphasise the saving which may be effected in the future by more skilful management, and by more favourable circumstances. These, however, are matters which, it is submitted, ought not to form the basis of an accountant's report on profits. Such reports should be rigidly based on facts, and although certain adjustments, as already indicated, may be desirable (and even necessary), so that a correct impression of these facts may be gathered, in view of the altered conditions which it is expected will exist, in no circumstances whatever should the report on profits degenerate into anything which could possibly be described as an estimate, or a guess, of what may in certain circumstances be expected to happen in the future.

The duties of an auditor with regard to the prospectus were referred to by Mr. Justice Humphries in his summing-up in *Rex v. Hinds, Musgrave and Steven* in the following terms:

'... and nobody, least of all Mr. Roberts, appearing on behalf of the defendant Steven, has attempted to minimise the importance of an auditor who is responsible

for a very, very important part of any prospectus inviting the public to subscribe, the importance of his exercising great care in every word that he puts in his report, and in particular, of course—because that is his peculiar province—to see that the accounts are correct, so far as he can possibly ascertain, and that any important item is fully explained. You will remember what Mr. Burleigh said in this case. He is not an auditor, although I expect he has done that work many times; he was speaking as an accountant. He said the great, important thing to aim at in accountancy—it is not a hocus-pocus sort of business done in the dark—the great, important thing is to let people know exactly what you are doing, and that you must leave it to them to judge what they will do finally. Let them understand the figures which you are putting before them.'

INVESTIGATION AND AUDIT. A regular audit professes to discover the true position of affairs. An investigation as to profits, made on behalf of a proposed company, professes to discover the position of affairs so far as it affects the particular object in view. In some respects the narrower field of an investigation will permit the accountant to reduce the scope of his examination; but, on the other hand, there are many points on which a greater strictness of inquiry is necessary. Thus, supposing the accountant to be acting on behalf of the purchasers of an undertaking, he may take it for granted that the accounts submitted to him by the vendors do not underestimate the profitable nature of the business, or the strength of its financial position. Consequently, it does not seem necessary that he should inquire with the same exhaustiveness that he would use in the case of an audit into the completeness with which every source of income has been duly accounted for; neither is it necessary for him meticulously to consider the validity of the various items of revenue expenditure charged in the accounts, nor to check such expenditure minutely with the vouchers. Capital expenditure should, however, be carefully vouched in order to guard against the possibility that it should in reality be charged against the revenue. On the other hand, if he is acting on behalf of the vendors, it is clearly desirable that both these points should receive careful attention, but in that case the investigation would not differ greatly from the complete audit; for it is obvious that he cannot authorise the submission of accounts to the proposed purchasers until he is satisfied that such accounts are true in all respects.

THE POSSIBILITY THAT FRAUD EXISTS. Yet another difference between investigations and audits must strike the observer. An ordinary audit always aims at the discovery of fraud; but an investigation as to profits does not involve any such inquiry, except in so far as the assets or profits might have been fraudulently overstated for the purpose of concealing defalcations, or of deliberately making the accounts appear unduly favourable.

Broadly speaking, there are two ways in which books may be falsified for the purpose of concealing fraud. The first method is by falsifying the balance sheet, either overstating assets or understating liabilities to cover the amount stolen; the second method is by falsifying the revenue account, by understating income or overstating expenses, so that the profit shown by the books may be reduced to the profit

which was actually netted by the proprietors, after deducting the amount misappropriated by the defaulting official.

If the first method has been adopted, the purchasers will not necessarily be prejudiced, for the profits shown by the books will have been the profits actually made; while the assets which appear in the books at an inflated price will usually be guaranteed as to value by the vendors or vouched for by the certificate of an independent valuer. Sometimes, however, the investigating accountant assumes responsibility for the accuracy of the scheduled book debts taken over by the proposed company, and in such cases it will, of course, be necessary for him to inquire carefully into their correctness.

Under the second method it would appear that the purchasers would actually gain by the defalcations of an official of the vendors, for the profits earned would be in excess of those shown by the books, while the latter would form the basis upon which the purchase price for goodwill was calculated; and, as the balance sheet would correctly record the financial position, there would obviously be no injustice done to the purchasers if these figures were taken as a basis for valuation. It is thought, therefore, that the investigating accountant acting on behalf of the proposed company need not trouble to go exhaustively into the question of the bona fides of the various expenses debited, his great object being to make sure that the expenses are completely recorded in the books submitted to him. On the other hand, he will require to look carefully into the nature of many transactions, e.g. those which affect any comparison between the past and the future. The difficulty of the investigating accountant's position arises from the fact that his real clients (i.e. those in whose interests he is acting) are an unknown, and, at the time, non-existent body. It is, therefore, obviously impossible for him to consult them in any way during the course of his investigation, and his only means of acquainting them with the result of his inquiry will be by means of his report.

SCOPE OF REPORT. In making an investigation as to profits for prospectus purposes, therefore, the accountant must be careful never to lose sight of the object for which his investigation is being made. That object may be said to be to enable the public to judge:

- (a) whether the business of the vendors is worth purchasing;
- (b) whether the business is worth the price asked for it by the vendors.

The accountant is not asked to express a definite opinion on either of these points, for it is obviously the business of each intending shareholder to answer these questions to his own satisfaction before applying for shares; but it is pointed out that the accountant's report forms almost the only basis on which the intending shareholder can judge the prospects of the proposed company, and it is therefore argued that it should be the accountant's aim so to conduct his investigation, and frame his report, that the materials necessary for a correct judgment may be placed before the public. At the same time the report should be a clear statement of accomplished facts, and not a

mere estimate of possible—or even probable—future results, misnamed a 'certificate'. To a limited extent (as indicated above) it may be permissible, and even desirable, to modify the past results so that they may more usefully serve the purpose for which they are primarily intended—namely, provide a reliable index of future profits. At the same time the report should relate not to the future, but to the past.

There is yet another point which the accountant must bear in mind. Inasmuch as he may be required at any future date to substantiate his report, he should make the most copious notes of all matters arising in the course of his investigation. These notes should not be confined to actual figures and calculations: whatever explanations he may have received in reply to his inquiries should be committed to writing, so that they may be available if required. If this be not attended to, and legal proceedings are subsequently instituted requiring the accountant to substantiate his report, his position will not be an enviable one for he will probably have to go over at least a portion of the ground a second time, and perhaps some of the evidence he formerly utilised may no longer be available.

METHOD OF PROCEDURE. STANDING OF VENDORS. Before actually commencing an investigation it is very desirable to make inquiries as to the position and character of both the promoters of the company and the proprietors of the undertaking. A man is always to be known by the company he keeps, and no one can afford to be mixed up with persons of doubtful reputation. Moreover, if a man bears a really bad character, it may safely be taken as being at least probable that the company in which he is concerned is not likely to prove a good investment to the public; and an accountant is not likely to do himself much good by connecting himself with 'shady' companies.

AUDITED AND UNAUDITED ACCOUNTS. If the books have been regularly audited by a professional accountant it is a good plan to seek an interview with him, and endeavour to ascertain the precise extent of his examination, and also his general opinion on the matter.

On the other hand, if there has been no regular audit—and *a fortiori* if the books have not even been regularly balanced—it seems as though the investigator could not, with safety, neglect an exhaustive inquiry into all the facts. Of course, objections may be raised to this statement, the most important being the objection that such a complete examination would occupy a much longer time than is ordinarily available for the purpose. It is, however, submitted that it is the accountant's duty to make an effective investigation—not the most effective investigation practicable in a limited period of time—and further, that he should so conduct affairs that he need not shrink from accepting the fullest responsibility as to the extent of his investigations.

NECESSITY FOR INSPECTING BALANCE SHEETS. Another general point at which it is desirable to draw attention is the danger of looking only to the revenue account for information as to profits.

(cases are not unknown in which—the assets being taken over at an agreed valuation—the investigating accountant has confined his attention entirely to the revenue account without concerning himself with the sufficiency or otherwise of the amounts written off for depreciation and bad debts; the result being that the certified profits 'as shown by the books' were greatly in excess of the profits actually earned. The accountant who aims at something more than pocketing his fees and keeping his skin whole will not rest satisfied with that kind of investigation.

SPECIAL POINTS FOR INVESTIGATION. Assuming that the accountant is about to commence an investigation into the profits of a manufacturing or trading concern during the past five (or more) years; with a view to it being purchased by a joint-stock company, the land, buildings, plant, and stock-in-trade being specially valued for that purpose by an independent valuer: assuming further that the accounts have been audited continuously by a firm of chartered accountants, who are satisfied as to their correctness; the question arises, what special points will the investigating accountant require to examine which do not arise in the ordinary course of a regular audit?

It may be observed at this point that the exacting requirements of the Companies Act, 1948, in regard to accounts and balance sheets, should in some respects make the task of the investigating accountant easier in the future than it has been in the past. For some time to come, however, the report will deal, in part, with years before the Act came into operation, and it will be borne in mind that the investigation may be concerned with a business not carried on by a company.

Taking first the several revenue accounts, it is advisable to ascertain that these are all drafted on the same basis. If then they are arranged in parallel columns (usually it is convenient to omit shillings and pence) the investigator will be in a position to make effective comparison and to note any tendencies which may be apparent. He will see whether or not the accounts indicate a steady and consistent condition of affairs; whether the turnover fluctuates materially; and whether increasing, at a standstill, or diminishing; whether the percentage of gross profit is fairly constant, and such as is usually earned in such undertakings. The cause of any material fluctuation in gross profit ratio must be ascertained, with a particular view to eliminating errors in stock-taking. It is also necessary to see that the expenses are reasonably steady. Special attention should be given to such items as advertising, exhibition expenses, &c. A marked reduction of expenses during the last year must be viewed with the greatest suspicion, for such reduction, if excessive, points to the possibility that the undertaking has been starved with a view to snatching an apparent profit; obviously, however, the real effect of this process on the fortunes of the undertaking may be serious and lasting.

So far as is reasonably practicable, the accountant must examine the bona fides of all sales, especially those recorded during the last few months. The prices of at least a portion should be compared with

current rates, and any remarkable increase in the amount of sales, or in the number of new accounts opened, should be regarded with suspicion. All sales 'on approval' must be disallowed, and where sales are post-dated it seems essential to make sure that they have actually gone out of stock. The entries for the next few weeks after the closing of the books should be carefully scanned, and if they show an exceptionally large number of returns, or an exceptionally small amount of sales, the accountant must draw his own conclusions as to the bonafides of the previous sales. In dealing with the question of consignments, he must remember that the goods have probably been invoiced at selling prices while the unsold balance can only be allowed for in the accounts at cost price (*plus* expenses) at most. Another point which must not be lost sight of is the question of travellers' commission: care must be taken to charge up commission upon all sales that are included in the accounts. Due allowance must also be made for all outstanding discounts; and empties which are returnable, but not yet returned, cannot safely be taken credit for at the full price charged. Transfers between branches must be reduced to original cost and must be eliminated both from sales and from purchases in the accounts of the business as a whole.

With regard to the purchases, the problem is similar to that relating to sales, but somewhat simpler, because the accountant can usually obtain statements from the creditors. It is, however, very necessary to be on one's guard against the omission of post-dated invoices when the goods have actually gone into stock.

Where reliable stock accounts and cost accounts have been kept, there exists a very valuable corroboration of the contents of the trading account; but where these cannot be obtained, the accountant must do his best with the material available. It is especially important that the various stock-takings should be conducted on similar lines—i.e. they should be based on the same scale of prices, due allowance being made for the depreciation of articles no longer in fashion, or in small quantities, and for 'out' sizes. If the various stock-lists have been prepared on different scales of prices they must be recast on a uniform method, as any difference may very materially alter the profits shown by the accounts. The valuation of the stock-in-trade made by the valuer should be compared with the vendor's stock-list, and if there is any material difference between the two, the accountant must not fail to examine the effect of the difference on the accounts. Thus, supposing he arrives at the conclusion that, throughout (say) the past five years the stock has been consistently over-valued, say, 15 per cent., and supposing the stock is £10,000 heavier at the present time than it was five years ago, then during those five years the net profits will have been overstated £1,500, or (say) £500 a year.

When the stock consists of such articles as cotton, iron, grain, lead, &c., which have a definite but unstable market value, the question of the legitimacy of profits arising from such alterations in value as may have occurred is a consideration of no light importance. It may be laid down (1) that no profit should be taken credit for on the rise in value of unsold stock, although revenue must be debited

with the contingent loss arising from any fall; (2) that no profit should be included as part of the trading or manufacturing profits that has arisen out of a 'gamble' pure and simple, but gambling losses cannot safely be ignored, and (3) that where any material portion of the profits has arisen from favourable fluctuations of value—as opposed to true commercial profits—it is very desirable that the two sources of profit should be distinguished in the accountant's report.

If there are any further items to the credit of the profit and loss account, the investigator will require to see that the profit has actually been earned, and that it is fairly incidental to the business of the undertaking. Even then, however, a purely exceptional source of profit (e.g. arising from the fact that an important exhibition had been held in that particular industry, or an altogether exceptional contract executed) should always be specially noted in the report.

Another point of importance may be mentioned here, although it does not immediately arise from the preceding considerations. Where the undertaking is of such a nature that it cannot be carried on advantageously except in the present premises, the accountant should satisfy himself that those premises will be conveyed to the company for a reasonable term. No sensible man would buy the goodwill of a hotel unless he could get a long lease, if not the freehold, of the hotel premises; while the goodwill of a music-hall held on a yearly tenancy would not usually be considered a good investment. If the lease is to be granted to the company at an increased rental, the fact must be mentioned in the report.

Turning now to the expenses debited to profit and loss account, the accountant will require to satisfy himself that every legitimate expense has been actually included. The ordinary current expenses present no special difficulty; but they must be accurately apportioned between the several periods; and a study of the accounts since the date of the last balance sheet will probably disclose any outstanding liabilities that have been omitted. Attention has already been called to the danger of a *mala fide* ruinous curtailment of expenses, so there is no occasion to dwell again on that point. The possibility that a proprietor may have met expenses out of his own drawings should be borne in mind.

There remains now the questions of bad debts. For the purpose of dealing with this point the accountant must refer to the balance sheets, as well as the profit and loss accounts; and, inasmuch as he is no longer in the realm of cut-and-dried facts, he must use the greatest circumspection in arriving at his ultimate opinion.

In dealing with bad debts, the fact that he is dealing with at least five years' accounts will help him to a certain extent, for it will enable him to strike an average and he can compare that average with what his experience and intelligence teach him to be reasonable for that class of undertaking. Again, the book debts of the first year, at least, are almost certain to be either collected or written off before the end of the fifth year, and he can compare the percentage of the first year's actual bad debts upon its sales with the percentage written off each year. Such a comparison is of necessity only tentative, but it

is useful so far as it goes. Then he can carefully examine the last schedule of book debts; the chances are that he will know a very appreciable proportion of the names there set down, and if he finds that the schedule contains names that some of his other clients look upon as bad or doubtful, he must draw his conclusions accordingly, to the best of his judgment. In any case, and in all circumstances, he will require to satisfy himself that the question of the provision for bad and doubtful debts has been honestly and fairly faced.

Particular attention should be paid to the closing year, because it is natural that promoters should desire to show a rising scale of profits. Every precaution should be taken to guard against illegitimate reduction of charges for expenses and against inflation of revenue at the expense of previous or later years.

I. (b) INVESTIGATION ON BEHALF OF PROPOSED PRIVATE PURCHASER OF A BUSINESS

The points to be borne in mind and the work to be done do not differ in essentials from the outline given above; but two circumstances create an important difference, viz. (i) no statutory requirements limit the free exercise of the investigator's own ideas and plans, and (ii) the investigator acts on behalf of a definite, known person with whom the whole matter can be discussed and to whom the final report can be addressed. It follows that the investigator is in a much freer position and, in fact, he usually presents a far fuller report than that which is demanded by the Companies Act where a prospectus is in question.

In this case, again, though the report relates to the past, the client requires it in order to guide him in connection with future action. The investigator must, therefore, be careful to bring out points which affect the *continuity* of the business and of existing conditions. The following points may be mentioned by way of suggestion:

- (i) As to management; will the existing proprietors continue to give their services and at what remuneration? Are there any 'key' men amongst the employees whose loss would be a serious detriment? At what cost could proprietors or 'key' men be replaced?
- (ii) As to the business itself; is it seasonal, speculative, dependent on some circumstance which may pass away? Does it require constant expenditure by way of advertising? Have the past results been obtained in consequence of conditions not likely to be repeated? Does the business exploit a monopoly and, if so, does this depend on a *personal* connection of the proprietor, the continuance of a patent or some other special circumstance? Is the business dependent on possession of existing premises and if so what prospect is there of continuance of tenure? What is the number of customers and is it possible to deduce anything from statistics of their distribution, &c.? What is the average of annual sales per customer, and of value of each order? Have these figures shown a tendency to rise or fall?

Does the business depend on obtaining large contracts and what is the prospect here? Are there any *unfavourable* contracts which must be taken over?

- (iii) As to competition; will the proprietors assist the business, remain neutral or compete? Is there anything to indicate that new competition, whether of other articles or of other suppliers of the same article, is springing up? Will it be possible to *purchase* on terms as favourable as hitherto?

II. (a) INVESTIGATION ON COMPANY RECONSTRUCTION

Here it is desirable that the investigator should have considerable experience of the financing of business operations, as he will probably be required to advise what offers to given classes of holders of capital may be regarded as equitable and likely to be accepted. It is important to remember that a mere rearrangement of the rights of members can never of itself turn a non-profitable business into a profitable one. Where, however, lost or over-valued assets are written down savings may result through reduction of depreciation charges; and where debenture interest can be reduced there is also a consequent saving.

Reconstruction may take two broad forms: (i) existing capital rights may be altered or reshuffled; or (ii) a new company may be formed to acquire the undertaking, the old shareholders receiving shares in the new concern. Students of accounting do not need to be reminded that there is a difference between the acquisition of the *assets* of an old concern and the acquisition of *shares* held by individual members thereof. In the latter case the new company becomes a holding company.

An important part of every report under this head is the construction of an outline balance sheet before and after the proposals are put into force; this should be accompanied by a statement comparing the distribution of different levels of profits amongst the various classes of claimants as between the old regime and the new. For reasons which have already been explained, although the question of the prospective new market prices of shares probably interests the recipients of the report the investigator should refrain from expressing any opinion thereon.

It is essential that the investigator should try to get at the real causes which have led to the existing situation. Questions of management come up for review and it is probable that the investigator's skilled advice will be welcomed. Finance is, however, usually the all-important factor and the manner in which the available capital has been disposed in the past is a most vital point, as is also the apparent reason why any special losses have been sustained.

The investigator's attention must be given to the question whether the proposals made appear likely to enable the management to avoid the errors and difficulties of the past and, in particular, whether a sufficiency of working capital seems assured.

II. (b) INVESTIGATION ON COMPANY AMALGAMATION

Amalgamation is resorted to where, for the purpose of effecting economies or of eliminating competition two or more existing successful companies are combined either by one absorbing the others or by the formation of a new company to acquire the assets or shares of all.

It is essential that the investigator should be quite clear whether he is acting for one party in the discussion, with a view to advising that party as to the best possible terms, or whether he is acting for all parties and is under a consequent duty to give impartial advice.

In these cases questions of past history usually recede into the background and the point of prominent importance is the *relative* capital values of the holdings of the various parties and the consideration to be taken by each in the form of an interest in the transferee company. Hence the main object is to arrive at the net present capital value of the assets of each company, *including goodwill*. The goodwill question will probably involve an examination of profits, mainly with a view to computing these over an agreed period, on the same basis, particularly in regard to such matters as depreciation, commissions, directors' remuneration, debenture interest, &c.

II. (c) INVESTIGATION ON CHANGES IN PARTNERSHIP

Here, again, the importance of being quite clear whether instructions emanate from the firm or from one or other side in the discussion cannot be too strongly stressed. The partnership agreement (whether by deed, or parol) must be most carefully examined and the provisions of the Partnership Act, 1890, must be recalled in so far as they supplement all agreements.

The question of goodwill is nearly always of prominent importance in these cases and the agreement must be carefully considered; in any event the parties must be carefully informed of the effect of book entries made.

A principle easily understood by professional men, but often overlooked by laymen, is the rule that (subject to agreement) outgoing partners retain their right to have the partnership assets sold to the highest bidder, i.e. partners who may conceive themselves to be 'continuing' partners have no inherent right to 'pay out' an outgoing partner by handing him the amount happening to appear at his credit in the partnership books; and this principle applies equally whether the late partner survives or is represented by executors.

III. (a) INVESTIGATION ON BEHALF OF CREDITOR

This examination can be carried out only with the consent of the debtor and it is desirable that all parties should agree beforehand on the scope of the information ultimately to be furnished to the creditor. In the case of an existing debt the object is usually to ascertain whether the debtor is 'good for' the sum in question, i.e. whether the liquid position is reasonably strong in relation to the existing liabilities. If, however, the advance in question is one not yet made the point for attention is the reason why the money is required; if for the discharge

of another existing debt a situation of suspicion is obviously created; otherwise the inquiry resolves itself into an assessment of the possibilities of making prudent and reproductive use of the money. In all cases the information furnished to the client should enable him to judge whether the proposed advance is in the nature of a 'lock up' or may genuinely be expected to 'turn itself over' so as to become available for repayment within a measurable period.

III. (b) INVESTIGATION IN CONNECTION WITH SUSPECTED FRAUD

For the present purpose fraud may be regarded as taking three forms, viz.: (i) abstraction of cash, (ii) abstraction of goods and (iii) falsification of final accounts for the purpose of obscuring the true position. Forms (i) and (ii) are usually practised by employees, while various forms of (iii) enable proprietors to enjoy the various fruits of apparent (but fictitious) success.

Where the honesty of an employee is called into question it is important to remember the British principle that it is for a court of law to assign guilt after proof and that meanwhile an accused person is to be deemed innocent. In all cases it is, therefore, wise studiously to refrain from making accusations of crime against individuals. The report should confine itself to stating, in effect, that given individuals should be asked (or have been asked unsuccessfully) to explain such and such transactions which appear irregular in stated respects.

Further, while assistance from persons apparently implicated need not be refused, it is a cardinal blunder to hold out inducement of reward as a means of obtaining information or assistance.

It is also, perhaps, not out of place to remind investigators that their reports will almost certainly come before lawyers; every man should confine himself to his own sphere and it is unwise to use technical terms of law in a report unless the writer is certain that words are correctly used. In this connection attention is called to the precise meaning of 'embezzlement' which is confined to the appropriation to his own use by a servant or clerk of money, &c., received by him from third parties for and on account of his employer; it is limited to cases where the property had not reached the actual or legal possession of the employer and differs thus from true larceny.

The first step is always to ascertain the precise scope of the suspected person's duties and thus to judge the opportunity which he had for misdeeds, both in respect of matters wholly within his own charge and in respect of the possibility of collusion with other persons. Next, the period to be examined must be decided, in accordance with the circumstances. On this point it may be said that a report on these matters can be regarded as satisfactory only when based on an *exhaustive* examination of the records concerned, but, in deciding where the exhaustive examination is to begin, a *test* of previous periods may be undertaken and not until a negative result has been produced by the tests can the commencing point of the investigation be safely fixed.

Where the suspected irregularities concern the received side of the cash book the investigator must realise clearly that he is searching for

items *not appearing in the books*, and consequently he must be on the lookout for evidence pointing to the existence of income not brought into the books. Needless to say, the counterfoils (or duplicates) of all receipt books must be traced into the cash book, special care being given to dates, names and amounts. Any apparent alterations must be closely scrutinised. The investigator must also assure himself that all receipt books have themselves been accounted for.

Special attention must be given to the accounts of debtors who are in the habit of paying otherwise than by cheque and to the existence of transactions of an unusual character such as rebates of customs duties, share transfer fees, sale of scrap, &c.

The bank pass book must be exhaustively compared with the cash book, special attention being given to dates, and the balance at the commencement and end of the period must be certified by the bank. All cash book additions (including the details of bank deposits) must be checked.

All credits, especially such matters as bad debts, in the accounts of debtors must be narrowly examined as these may have been falsely introduced to take the place of money misappropriated. The employer should be asked to scrutinise the discounts allowed as the relative items may actually have been paid in full or under a lower rate of discount.

A familiar form of fraud consists in the *delayed* accounting for money received, or in the abstraction of money received from A., this being later made up out of money received from B., although entered under the name of A. Sooner or later the cashier who embarks on this form of fraud must be under the necessity of splitting cheques, and the matter may be discovered by examining the *originals* of the paying-in slips (obtained from the bank) in detail with the cash book.

The proceeds of the bills receivable must be traced into the bank and the bills not yet matured, and in hand, must be examined. Very particular attention must be given to the bank reconciliation and the reader's attention is drawn to the remarks under this head in the body of this work.

In many cases, especially where irregularities have been extensively practised, recourse must be had to circularisation of debtors with a view to agreement of the sold ledger balances. The obvious practical objections to this course usually disappear when it is pointed out that the circular need be of no more harmful a character than a rubber stamping on a statement of account. The desirability of direct mailing of these statements need not be emphasised.

Lastly, there remain the possibilities that sales of goods may have been omitted from the books with a deliberate view to the misappropriation of the relative cash, and that cash sales may have been tampered with. The first possibility may be dealt with by examining order books and records of goods despatched, while cash sales can only be checked in relation to the system of internal check existing. Very material suppression of sales will, of course, reveal itself by affecting the ratio of gross profit.

Where the suspected fraud is on the payments side of the cash book

the investigator's task is usually less difficult, since it resolves itself into an exhaustive vouching of the payments recorded, although it must be pointed out that all expenses (including wages, &c.) must be vouched, as well as bought ledger items. It is not enough, however, merely to vouch the cash book payments without going back to the original validation of the incurring of the expenditure. The point in mind is that false invoices for goods or services may have been introduced into the books in favour of the *alias* of the suspected person. In these cases it is obvious that no checking of the cash book alone will reveal irregularity for the miscreant will certainly see to it that a perfect receipt is placed on the voucher file; the examination is rather to be directed to the ordering system and to the routine of checking invoices with the actual receipt of goods. Invoices marked 'duplicate' should be looked at carefully, lest the original should also have been passed through. In partnership cases the attention of partners should be called to all items charged against them as drawings, particularly where such sums are included in weekly wages cheques.

Whether petty cash is to be exhaustively examined is a matter to be decided in the particular circumstances of each case, but the word 'petty' should not be allowed to blind the investigator to the fact that very often substantial sums are expended through this channel. In every case all cheques drawn for petty cash should be traced in detail to the debit side of the petty cash book and the addition of the latter should be checked, at least as regards the pounds column.

Where the suspected person had extensive control of the whole system of book-keeping and of the business generally an investigation for fraud resolves itself into a complete audit of the books with the difference that whereas in an ordinary audit the auditor does not commence with a suspicious (as distinct from an *alert*) mind, in this case he is forewarned that irregularities do exist and he is accordingly suspicious of all the entries. Mention must be made that in such cases unexplained transfers across the face of the books are often pointers to the existence of irregularities; this is particularly so in connection with such concerns as importing and exporting agencies, where goods are bought and sold on behalf of other persons, or estate agents where rents are collected on behalf of clients. These transfers are often resorted to as a fraudulent means of temporarily reconciling the ledger balance with the true balance which has to be reported to the customer or client.

Where fraud takes the grander form of deliberate tampering with results by proprietors or managers, usually with a view to justifying commissions to themselves and/or dividends to shareholders, or loans from bankers, there is nearly always present an overstatement of assets or an understatement of liabilities. The valuation of stock calls for the closest scrutiny, as does the question whether invoices for all goods in stock have been passed through the books. Expenditure charged to capital must be very carefully agreed. Debtors must be subjected to the usual examination, subject to the additional point that the persons bent on misrepresentation can, in this case, usually operate on the accounts recording transactions with subsidiary and

allied companies. There are instances in plenty where the game of 'robbing Peter to pay Paul' has continued undetected for years and the investigator must spare no pains to get thoroughly to the bottom of the history of debts alleged to be due from these sources. Similarly the taking of profits in respect of 'paper' transactions must be looked at with the greatest care.

III. (c) INVESTIGATION IN CONNECTION WITH TAXATION LIABILITIES

This heading must be treated with due regard to the necessity of keeping within the scope of this book; that is to say, that the very large subject of income-tax *per se* must be left on one side. Accountants are, however, often asked to investigate cases where income-tax assessments are in dispute and a few words may usefully be devoted to the general aspects of the subject.

First, then, duty to the client demands that he be advised emphatically that if any falsity towards the Inland Revenue has been practised he should *at once* go to the authorities and disclose the whole matter. If he will not, the engagement should be declined. In cases of fraud, it is the practice of the authorities to be influenced by the fact that disclosure originates with the taxpayer. The following statement was made by the Chancellor of the Exchequer in Parliament on 5th October, 1944:

'The practice of the Commissioners in this matter is governed by Section 34 of the Finance Act, 1942, which makes provision for the admissibility in evidence of any disclosure made in the circumstances there set out. As the section indicates, the Commissioners have a general power under which they can accept pecuniary settlements instead of instituting criminal proceedings in respect of fraud or wilful default alleged to have been committed by a taxpayer. They can, however, give no undertaking to a taxpayer in any such case that they will accept such a settlement and refrain from instituting criminal proceedings even if the case is one in which the taxpayer has made full confession and has given full facilities for investigation of the facts. They reserve to themselves complete discretion in all cases as to the course which they will pursue, but it is their practice to be influenced by the fact that the taxpayer has made a full confession and has given full facilities for investigation into his affairs and for examination of such books, papers, documents or information as the Commissioners may consider necessary.'

In tax matters the investigator must realise that he has a public duty as well as a duty to his client, and that while it is incumbent on him to see that his client receives the benefit of every allowance and concession which the law provides, yet it is equally his duty to see that the Inland Revenue receives a 'fair deal' and that no *mala fides* or *suppressio veri* is practised towards the authorities.

For the rest, the investigation resembles an ordinary investigation of profits with the addition that it is necessary to remember that 'statutory income' for income-tax purposes is a figure different from book profits in respect that there are many classes of legitimate business expenses which are not allowable for tax purposes, while, on the other hand, many business receipts do not fall within the ambit of assessable profits.

Income-tax throws a great strain on human integrity and the investi-

gator must always carry in his mind the possibility that his client may be ready to shield himself behind his professional adviser. Every possible test must therefore be applied to ascertain whether the disclosed income is consonant (i) with the style of living of the client and (ii) with the balance sheets prepared at successive periods. A frequent, if gross, form of fraud is the keeping of two sets of books, one true and the other 'manufactured' for income-tax purposes.

As to the report made, there is a special need (particularly where it is to be handed to the Inland Revenue) that the precise extent to which the investigator can take responsibility for the figures disclosed should be indicated.

III. (d) INVESTIGATION IN CONNECTION WITH SHARE TRANSFERS

What is sometimes called a 'share transfer audit' is here treated under the head of Investigation in order to emphasise the fact that it is no part of an ordinary company audit. Under the Companies Act the duty of an auditor in this respect is complete when he has satisfied himself that the total number of shares (or amount of stock) in the company's register of members agrees with the issued capital as stated in the balance sheet.

A special arrangement is sometimes made, however, by which the auditor is instructed to check the transfers of shares in successive periods. The opportunity is here taken, therefore, to indicate the main points which must receive attention.

As a preliminary the form of transfer must be agreed with the company's articles, and any conditions contained in those articles must be noted.

Each transferor should have been notified, by the company, of the lodgment of the transfer, and inquiry should be made whether any objections have been received.

All the incidents of each transfer (including stamp) should be scanned and the name of transferor with class and number of shares both arithmetical and serial should be agreed with the old certificates and the register of members. The old certificates should thereupon be cancelled. Where a certificate is lost a letter of indemnity should be forthcoming. If the transfer is executed by an agent, his signature should be compared with the specimen received on registration of the power of attorney. Signatures of parties abroad should be attested by the local consul, notary, &c. Attention should be called to the transfer of any shares on which calls made have not been paid.

The balance receipts given for any portions of blocks of shares not transferred should be inspected and the particulars followed to the counterfoils.

Notices in lieu of *distringas* must be duly observed and notice must be given thereunder.

When the transfers have been passed by the board the postings therefrom must be checked to the register of members (*via* the register of transfers, if any) and to the new certificates and counterfoils thereof. They must also be agreed with the directors' minute

book and seal book. In connection with the names of transferees it must be remembered that no notice of any trust must be entered on the register of members, that shares cannot be held in the name of a firm and that incorporated companies should be accepted only if they have power to hold shares under their memoranda of association.

When balance receipts are returned they should be checked with the new certificates and counterfoils thereof.

Finally the transfer fee chargeable on each transfer should be followed into the bank.

APPENDIX A

EXTRACTS FROM STATUTES AND REGULATIONS REFERRED TO IN THE COURSE OF THIS WORK

GENERAL

LARCENY ACT, 1861 24 & 25 Vict. Ch. 96

Keeping Fraudulent Accounts

82. Whosoever, being a director, public officer, or manager of any body corporate or public company, shall as such receive or possess himself of any of the property of such body corporate or public company otherwise than in payment of a just debt or demand, and shall, with intent to defraud, omit to make, or to cause or direct to be made, a full and true entry thereof in the books and accounts of such body corporate or public company, shall be guilty of a misdemeanour, and being convicted thereof shall be liable, at the discretion of the Court, to any of the punishments which the Court may award as hereinbefore last mentioned.

Wilfully Destroying Books, &c.

83. Whosoever, being a director, manager, public officer, or member of any body corporate or public company, shall, with intent to defraud, destroy, alter, mutilate, or falsify any book, paper, writing, or valuable security belonging to the body corporate or public company, or make or concur in the making of any false entry or omit or concur in omitting any material particular, in any book of account or other document, shall be guilty of a misdemeanour, and being convicted thereof shall be liable, at the discretion of the Court, to any of the punishments which the Court may award as hereinbefore last mentioned.

Publishing False Statements

84. Whosoever, being a director, manager, or public officer of any body corporate or public company, shall make, circulate, or publish, or concur in making, circulating, or publishing, any written statement or account which he shall know to be false in any material particular, with intent to deceive or defraud any member, shareholder, or creditor of such body corporate or public company, or with intent to induce any person to become a shareholder or partner therein, or to entrust or advance any property to such body corporate or public company, or to enter into any security for the benefit thereof, shall be guilty of a misdemeanour, and being convicted thereof shall be liable, at the discretion of the Court, to any of the punishments which the Court may award as hereinbefore last mentioned.

LARCENY ACT, 1916 6 & 7 Geo. 5, Ch. 50

Larceny and Embezzlement by Clerks or Servants

7. Every person who—

- (1) being a clerk or servant or person employed in the capacity of a clerk or servant—
 - (a) steals any chattel, money, or valuable security belonging to or in the possession or power of his master or employer; or
 - (b) fraudulently embezzles the whole or any part of any chattel, money or valuable security delivered to or received or taken into possession by him for or in the name or on the account of his master or employer:

- (2) being employed in the public service of His Majesty or in the police of any place whatsoever—
 - (a) steals any chattel, money, or valuable security belonging to or in the possession of His Majesty or entrusted to or received or taken into possession by such person by virtue of his employment; or
 - (b) embezzles or in any manner fraudulently applies or disposes of for any purpose whatsoever except for the public service any chattel, money, or valuable security entrusted to or received or taken into possession by him by virtue of his employment:
- (3) being appointed to any office or service by or under a local marine board—
 - (a) fraudulently applies or disposes of any chattel, money, or valuable security received by him (whilst employed in such office or service) for or on account of any local marine board, or for or on account of any other public board or department, for his own use or any use or purpose other than that for which the same was paid, entrusted to, or received by him; or
 - (b) fraudulently withholds, retains, or keeps back the same, of any part thereof, contrary to any lawful directions or instructions which he is required to obey in relation to his office or service aforesaid;

shall be guilty of felony and on conviction thereof liable to penal servitude for any term not exceeding fourteen years, and in the case of a clerk or servant or person employed for the purpose or in the capacity of a clerk or servant, if a male under the age of sixteen years, to be once privately whipped in addition to any other punishment to which he may by law be liable.

Conversion

20.—(1) Every person who—

- (i) being entrusted either solely or jointly with any other person with any power of attorney for the sale or transfer of any property, fraudulently sells, transfers, or otherwise converts the property or any part thereof to his own use or benefit, or the use or benefit of any person other than the person by whom he was so entrusted; or
- (ii) being a director, member or officer of any body corporate or public company, fraudulently takes or applies for his own use or benefit, or for any use or purposes other than the use or purposes of such body corporate or public company, any of the property of such body corporate or public company; or
- (iii) being authorised to receive money to arise from the sale of any annuities or securities purchased, or transferred under the provisions of Part V of the Municipal Corporations Act, 1882, or under any Act repealed by that Act, or under the Municipal Corporation Mortgages, &c., Act, 1860, or any dividends thereon or any other such money as is referred to in the said Acts, appropriates the same otherwise than as directed by the said Acts, or by the Local Government Board or the Treasury (as the case may be) in pursuance thereof; or
- (iv) (a) being entrusted either solely or jointly with any other person with any property in order that he may retain in safe custody or apply, pay, or deliver, for any purpose or to any person, the property or any part thereof or any proceeds thereof; or
 (b) having either solely or jointly with any other person received any property for or on account of any other person; fraudulently converts to his own use or benefit, or the use or benefit of any other person, the property or any part thereof or any proceeds thereof;

shall be guilty of a misdemeanour, and on conviction thereof liable to penal servitude for any term not exceeding seven years.

(2) Nothing in paragraph (iv) of subsection (1) of this section shall apply to or affect any trustee under any express trust created by a deed or will, or any mortgagee of any property, real or personal, in respect of any act done by the trustee or mortgagee in relation to the property comprised in or affected by any such trust or mortgage.

Conversion by Trustee

21. Every person who, being a trustee as hereinafter defined, of any property for the use or benefit either wholly or partially of some other person, or for any public or charitable purpose, with intent to defraud converts or appropriates the same or any part thereof to or for his own use or benefit, or the use or benefit of any person other than such person as aforesaid, or for any purpose other than such public or charitable purpose as aforesaid, or otherwise disposes of or destroys such property or any part thereof, shall be guilty of a misdemeanour, and on conviction thereof liable to penal servitude for any term not exceeding seven years. Provided that no prosecution for any offence included in this section shall be commenced.

- (a) by any person without the sanction of the Attorney-General, or, in case that office be vacant, of the Solicitor-General;
- (b) by any person who has taken any civil proceedings against such trustee, without the sanction also of the Court or Judge before whom such civil proceedings have been had or are pending.

FALSIFICATION OF ACCOUNTS ACT, 1875

38 & 39 Vict. Ch. 24

1. That if any clerk, officer, or servant, or any person employed or acting in the capacity of a clerk, officer, or servant, shall wilfully and with intent to defraud, destroy, alter, mutilate, or falsify any book, paper, writing, valuable security, or account which belongs to or is in the possession of his employer, or has been received by him for or on behalf of his employer, or shall wilfully, and with intent to defraud, make, or concur in making, any false entry in, or omit or alter, or concur in omitting or altering, any material particular from, or in any such book, or any document or account, then in every such case the person so offending shall be guilty of a misdemeanour, and be liable to be kept in penal servitude for a term not exceeding seven years, or to be imprisoned with or without hard labour for any term not exceeding two years.

2. It shall be sufficient in any indictment under this Act to allege a general intent to defraud, without naming any particular person to be defrauded.

It is further declared (Section 3) that 'this Act shall be read as one with the Act of the twenty-fourth and twenty-fifth of Her Majesty, Chapter ninety-six', Section 82 of which makes it a misdemeanour on the part of any director, public officer, or manager of any body corporate or public company, who shall 'as such receive or possess himself of any of the property of such body corporate or public company, otherwise than in payment of a just debt or demand, and shall, with intent to defraud, omit to make, or to cause or direct to be made, a full and true entry thereof in the books or accounts of such body corporate or public company'. The following section (83) makes it a misdemeanour on the part of any such person, who shall 'with intent to defraud, destroy, alter, mutilate, or falsify any book, paper, writing, or valuable security belonging to the body corporate or public company, or make, or concur in the making of any false entry, or omit, or concur in omitting, any material particular in any book of account or other document'. And Section 84 makes it a similar offence on the part of any such person who 'shall make, circulate, or publish, or concur in making, circulating, or publishing, any written statement or account which he shall know to be false in any material particular, with intent to deceive or defraud any member, shareholder, or creditor, of such body corporate or public company, or with intent to induce any person to become a shareholder, or partner therein, or to entrust or advance any property to such body corporate or public company, or to enter into any security for the benefit thereof'.

PREVENTION OF CORRUPTION ACT, 1906

6 Edw. 7 Ch. 34

Be it enacted by the King's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same as follows:

- 1.—(1) If any agent corruptly accepts or obtains, or agrees to accept or attempts to obtain, from any person, for himself or for any other person, any gift or consideration as an inducement or reward for doing or forbearing to do, or for having after the passing of this Act done or forborne to do, any act in relation to his principal's affairs or business, or for showing or forbearing to show favour or disfavour to any person in relation to his principal's affairs or business: or

If any person corruptly gives or agrees to give or offers any gift or consideration to any agent as an inducement or reward for doing or forbearing to do, or for having after the passing of this Act done or forborne to do, any act in relation to his principal's affairs or business, or for showing or forbearing to show favour or disfavour to any person in relation to his principal's affairs or business; or

If any person knowingly gives to any agent, or if any agent knowingly uses with intent to deceive his principal, any receipt, account, or other document in respect of which the principal is interested, and which contains any statement which is false or erroneous or defective in any material particular, and which to his knowledge is intended to mislead the principal; he shall be guilty of a misdemeanour, and shall be liable on conviction on indictment to imprisonment, with or without hard labour, for a term not exceeding two years, or to a fine not exceeding five hundred pounds, or to both such imprisonment and such fine, or on summary conviction to imprisonment, with or without hard labour, for a term not exceeding four months, or to a fine not exceeding fifty pounds, or to both such imprisonment and such fine.

(2) For the purposes of this Act the expression 'consideration' includes valuable consideration of any kind; the expression 'agent' includes any person employed by or acting for another; and the expression 'principal' includes an employer.

(3) A person serving under the Crown or under any corporation or any municipal borough, county, or district council, or any board of guardians, is an agent within the meaning of this Act.

2.—(1) A prosecution for an offence under this Act shall not be instituted without the consent, in England of the Attorney-General or Solicitor-General, and in Ireland of the Attorney-General or Solicitor-General for Ireland.

(2) The Vexatious Indictments Act, 1859, as amended by any subsequent enactment, shall apply to offences under this Act as if they were included among the offences mentioned in Section 1 of that Act.

(3) Every information for any offence under this Act shall be upon oath.

(4) The expenses of any prosecution on indictment under this Act shall be defrayed as in cases of indictment for felony.

(5) A Court of Quarter Sessions shall not have jurisdiction to inquire of, hear, and determine prosecutions on indictments for offences under this Act.

(6) Any person aggrieved by a summary conviction under this Act may appeal to a Court of Quarter Sessions.

3. This Act shall extend to Scotland, subject to the following modifications:

(1) Section 2 shall not extend to Scotland:

(2) In Scotland all offences which are punishable under this Act on summary conviction shall be prosecuted before the sheriff in manner provided by the Summary Jurisdiction (Scotland) Acts.

4.—(1) This Act may be cited as the Prevention of Corruption Act, 1906.

(2) This Act shall come into operation on the first day of January, nineteen hundred and seven.

PARTNERSHIPS

THE PARTNERSHIP ACT, 1890

53 & 54 *Vict. Ch.* 39

21. Unless the contrary intention appears, property bought with money belonging to the firm is deemed to have been bought on account of the firm.

24. The interests of partners in the partnership property, and their rights

and duties in relation to the partnership, shall be determined subject to any agreement, express or implied, between the partners by the following rules:

- (1) All the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses, whether of capital or otherwise, sustained by the firm.
- (2) The firm must indemnify every partner in respect of payments made and personal liabilities incurred by him.
 - (a) In the ordinary and proper conduct of the business of the firm; or
 - (b) In or about anything necessarily done for the preservation of the business or property of the firm
- (3) A partner making, for the purpose of the partnership, any actual payment or advance beyond the amount of capital which he has agreed to subscribe, is entitled to interest at the rate of five per cent. per annum from the date of the payment or advance.
- (4) A partner is not entitled, before the ascertainment of profits, to interest on the capital subscribed by him.
- (5) Every partner may take part in the management of the partnership business.
- (6) No partner shall be entitled to remuneration for acting in the partnership business.
- (7) No person may be introduced as a partner without the consent of all existing partners.
- (8) Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners, but no change may be made in the nature of the partnership business without the consent of all existing partners.
- (9) The partnership books are to be kept at the place of business of the partnership (or the principal place, if there is more than one), and every partner may, when he thinks fit, have access to and inspect and copy any of them.

28. Partners are bound to render true accounts and full information of all things affecting the partnership to any partner or his legal representatives.

29.—(1) Every partner must account to the firm for any benefit derived by him without the consent of the other partners from any transaction concerning the partnership, or from any use by him of the partnership property, name, or business connection.

(2) This section applies also to transactions undertaken after a partnership has been dissolved by the death of a partner, and before the affairs thereof have been completely wound up, either by any surviving partner or by the representatives of the deceased partner.

39. On the dissolution of a partnership, every partner is entitled, as against the other partners in the firm, and all persons claiming through them in respect of their interests as partners, to have the property of the partnership applied in payment of the debts and liabilities of the firm, and to have the surplus assets, after such payment, applied in payment of what may be due to the partners respectively, after deducting what may be due from them as partners to the firm; and for that purpose any partner or his representatives may, on the termination of the partnership, apply to the Court to wind up the business and affairs of the firm.

40. Where one partner has paid a premium to another on entering into a partnership for a fixed term, and the partnership is dissolved before the expiration of that term otherwise than by the death of a partner, the Court may order the repayment of the premium, or of such part thereof as it thinks just, having regard to the terms of the partnership contract, and to the length of time during which the partnership has continued: unless—

- (a) the dissolution is, in the judgment of the Court, wholly or chiefly due to the misconduct of the partner who paid the premium; or,
- (b) the partnership has been dissolved by an agreement containing no provision for a return of any part of the premium.

42.—(1) Where any member of a firm has died, or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm, with its capital or assets, without any final settlement of accounts as between the firm and the outgoing partner or his estate, then, in the absence of any agreement to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since the dissolution as the Court may find to be attributable to the use of his share of the partnership assets, or to interest at the rate of five per centum per annum on the amount of his share of the partnership assets.

(2) Provided that where by the partnership contract an option is given to surviving or continuing partners to purchase the interest of the deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner, or his estate, as the case may be, is not entitled to any further or other share of profits: but if any partner, assuming to act in exercise of the option, does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section.

43. Subject to any agreement between the partners, the amount due from surviving or continuing partners to an outgoing partner, or the representative of a deceased partner, in respect of the outgoing or deceased partner's share, is a debt accruing at the date of the dissolution or death.

44. In settling accounts between the partners after dissolution of partnership, the following rules shall, subject to any agreement, be observed:

- (a) Losses, including losses and deficiencies of capital shall be paid first out of profits, next out of capital, and lastly, if necessary, by the partners individually in the proportion in which they were entitled to share profits:
- (b) The assets of the firm, including the sums, if any, contributed by the partners to make up losses or deficiencies of capital, shall be applied in the following manner and order:
 - (1) In paying the debts and liabilities of the firm to persons who are not partners therein:
 - (2) In paying to each partner rateably what is due from the firm to him for advances as distinguished from capital:
 - (3) In paying to each partner rateably what is due from the firm to him in respect of capital:
 - (4) The ultimate residue, if any, shall be divided among the partners in the proportion in which profits are divisible.

THE LIMITED PARTNERSHIPS ACT, 1907

7 Edw. 7 Ch. 24

Commencement of Act

2. This Act shall come into operation on the first day of January, one thousand nine hundred and eight.

Interpretation of Terms

3. In the construction of this Act the following words and expressions shall have the meanings respectively assigned to them in this section, unless there be something in the subject or context repugnant to such construction:

'Firm', 'firm-name', and 'business' have the same meanings as in the Partnership Act, 1890 (53 & 54 Vict. Ch. 39):

'General partner' shall mean any partner who is not a limited partner as defined by this Act.

Definition and Constitution of Limited Partnership

4.—(1) From and after the commencement of this Act limited partnerships may be formed in the manner and subject to the conditions by this Act provided.

(2) A limited partnership shall not consist, in the case of a partnership carrying on the business of banking, of more than ten persons, and, in the case of any other partnership, of more than twenty persons, and must consist of one or more

persons called general partners, who shall be liable for all debts and obligations of the firm, and one or more persons to be called limited partners, who shall at the time of entering into such partnership contribute thereto a sum or sums as capital or property valued at a stated amount, and who shall not be liable for the debts or obligations of the firm beyond the amount so contributed.

(3) A limited partner shall not during the continuance of the partnership, either directly or indirectly, draw out or receive back any part of his contribution, and if he does so draw out or receive back any such part shall be liable for the debts and obligations of the firm up to the amount so drawn out or received back.

(4) A body corporate may be a limited partner.

Registration of Limited Partnership Required

5. Every limited partnership must be registered as such in accordance with the provisions of this Act, or in default thereof it shall be deemed to be a general partnership, and every limited partner shall be deemed to be a general partner.

Modifications of General Law in case of Limited Partnerships

6.—(1) A limited partner shall not take part in the management of the partnership business, and shall not have power to bind the firm:

Provided that a limited partner may by himself or his agent at any time inspect the books of the firm and examine into the state and prospects of the partnership business, and may advise with the partners thereon.

If a limited partner takes part in the management of the partnership business he shall be liable for all debts and obligations of the firm incurred while he so takes part in the management as though he were a general partner.

(2) A limited partnership shall not be dissolved by the death or bankruptcy of a limited partner, and the lunacy of a limited partner shall not be a ground for dissolution of the partnership by the Court unless the lunatic's share cannot be otherwise ascertained and realised.

(3) In the event of the dissolution of a limited partnership its affairs shall be wound up by the general partners unless the Court otherwise orders.

(5) Subject to any agreement expressed or implied between the partners—

- (a) Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the general partners;
- (b) A limited partner may, with the consent of the general partners, assign his share in the partnership, and upon such an assignment the assignee shall become a limited partner with all the rights of the assignor;
- (c) The other partners shall not be entitled to dissolve the partnership by reason of any limited partner suffering his share to be charged for his separate debt;
- (d) A person may be introduced as a partner without the consent of the existing limited partners;
- (e) A limited partner shall not be entitled to dissolve the partnership by notice.

Law as to Private Partnerships to apply where not Excluded by this Act

7. Subject to the provisions of this Act, the Partnership Act, 1890 (53 & 54 Vict. Ch. 39), and the rules of equity and of common law applicable to partnerships, except so far as they are inconsistent with the express provisions of the last-mentioned Act, shall apply to limited partnerships.

Manner and Particulars of Registration

8. The registration of a limited partnership shall be effected by sending by post or delivering to the Registrar at the register office in that part of the United Kingdom in which the principal place of business of the limited partnership is situated or proposed to be situated a statement signed by the partners containing the following particulars:

- (a) The firm-name;
- (b) The general nature of the business;
- (c) The principal place of business;
- (d) The full name of each of the partners;
- (e) The term, if any, for which the partnership is entered into, and the date of its commencement;
- (f) A statement that the partnership is limited, and the description of every limited partner as such;
- (g) The sum contributed by each limited partner, and whether paid in cash or how otherwise.

Registration of Changes in Partnerships

9.—(1) If during the continuance of a limited partnership any change is made or occurs in—

- (a) the firm-name;
- (b) the general nature of the business;
- (c) the principal place of business;
- (d) the partners or the name of any partner;
- (e) the term or character of the partnership;
- (f) the sum contributed by any limited partner;
- (g) the liability of any partner by reason of his becoming a limited instead of a general partner or a general instead of a limited partner;

a statement, signed by the firm, specifying the nature of the change, shall within seven days be sent by post or delivered to the Registrar at the register office in that part of the United Kingdom in which the partnership is registered.

(2) If default is made in compliance with the requirements of this section each of the general partners shall on conviction under the Summary Jurisdiction Acts be liable to a fine not exceeding one pound for each day during which the default continues.

Advertisement in Gazette of Statement of General Partner becoming a Limited Partner and of Assignment of Share of Limited Partner

10.—(1) Notice of any arrangement or transaction under which any person will cease to be a general partner in any firm, and will become a limited partner in that firm, or under which a share of a limited partner in a firm will be assigned to any person, shall be forthwith advertised in the *Gazette*, and until notice of the arrangement or transaction is so advertised, the arrangement or transaction shall, for the purposes of this Act, be deemed to be of no effect.

(2) For the purposes of this section, the expression 'the *Gazette*' means—

In the case of a limited partnership registered in England, the *London Gazette*;

In the case of a limited partnership registered in Scotland, the *Edinburgh Gazette*;

In the case of a limited partnership registered in Ireland, the *Dublin Gazette*.

Ad Valorem Stamp Duty on Contributions by Limited Partners

11. The statement of the amount contributed by a limited partner, and a statement of any increase in that amount, sent to the Registrar for registration under this Act, shall be charged with an *ad valorem* stamp duty of five shillings for every one hundred pounds, and any fraction of one hundred pounds over any multiple of one hundred pounds, of the amount so contributed, or of the increase of that amount, as the case may be; and in default of payment of stamp duty thereon as herein required, the duty with interest thereon at the rate of five per cent. per annum from the date of delivery of such statement shall be a joint and several debt to His Majesty, recoverable from the partners, or any of them, in the said statements named, or, in the case of an increase, from all or any of the said partners whose discontinuance in the firm shall not, before the date of delivery of such statement of increase, have been duly notified to the Registrar.

Making False Returns to be Misdemeanour

12. Every one commits a misdemeanour, and shall be liable to imprisonment with hard labour for a term not exceeding two years, who makes, signs, sends,

or delivers for the purpose of registration under this Act any false statement known by him to be false.

Registrar to File Statement and Issue Certificate of Registration

13. On receiving any statement made in pursuance of this Act the Registrar shall cause the same to be filed, and he shall send by post to the firm from whom such statement shall have been received a certificate of the registration thereof.

Register and Index to be Kept

14. At each of the register offices hereinafter referred to the Registrar shall keep, in proper books to be provided for the purpose, a register and an index of all the limited partnerships registered as aforesaid, and of all the statements registered in relation to such partnerships.

Registrar of Joint Stock Companies to be Registrar under Act

15. The Registrar of Joint Stock Companies shall be the Registrar of Limited Partnerships, and the several offices for the registration of joint-stock companies in London, Edinburgh, and Dublin shall be the offices for the registration of limited partnerships carrying on business within those parts of the United Kingdom in which they are respectively situated.

Inspection of Statements Registered

16.—(1) Any person may inspect the statements filed by the Registrar in the register offices aforesaid, and there shall be paid for such inspection such fees as may be appointed by the Board of Trade, not exceeding one shilling for each inspection; and any person may require a certificate of the registration of any limited partnership, or a copy of or extract from any registered statement, to be certified by the Registrar, and there shall be paid for such certificate of registration, certified copy, or extract such fees as the Board of Trade may appoint, not exceeding two shillings for the certificate of registration, and not exceeding sixpence for each folio of seventy-two words, or in Scotland for each sheet of two hundred words.

(2) A certificate of registration, or a copy of or extract from any statement registered under this Act, if duly certified to be a true copy under the hand of the Registrar or one of the Assistant Registrars (whom it shall not be necessary to prove to be the Registrar or Assistant Registrar) shall, in all legal proceedings, civil or criminal, and in all cases whatsoever be received in evidence.

Power to Board of Trade to Make Rules

17. The Board of Trade may make rules (but as to fees with the concurrence of the Treasury) concerning any of the following matters:

- (a) The fees to be paid to the Registrar under this Act, so that they do not exceed in the case of the original registration of a limited partnership the sum of two pounds, and in any other case the sum of five shillings;
- (b) The duties or additional duties to be performed by the Registrar for the purposes of this Act;
- (c) The performance by Assistant Registrars and other officers of acts by this Act required to be done by the Registrar;
- (d) The forms to be used for the purposes of this Act;
- (e) Generally the conduct and regulation of registration under this Act and any matters incidental thereto.

REGISTRATION OF BUSINESS NAMES ACT, 1916*

6 & 7 Geo. 5, Ch. 58

Firms and Persons to be registered

1. Subject to the provisions of this Act—

- (a) Every firm having a place of business in the United Kingdom and carrying on business under a business name which does not consist of the true surnames of all partners who are individuals and the corporate names of all partners who are corporations without any addition other than the true

* This Act has been amended by the Companies Act, 1947.

Christian names of individual partners or initials of such Christian names.

- (b) Every individual having a place of business in the United Kingdom and carrying on business under a business name which does not consist of his true surname without any addition other than his true Christian names or the initials thereof;
- (c) Every individual or firm having a place of business in the United Kingdom who, or a member of which, has either before or after the passing of this Act changed his name, except in the case of a woman in consequence of marriage;

shall be registered in the manner directed by this Act:

Provided that—

- (i) where the addition merely indicates that the business is carried on in succession to a former owner of the business, that addition shall not of itself render registration necessary; and
- (ii) where two or more individual partners have the same surname, the addition of an s at the end of that surname shall not of itself render registration necessary; and
- (iii) where the business is carried on by a trustee in bankruptcy, or a receiver or manager appointed by any Court, registration shall not be necessary, and
- (iv) a purchase or acquisition of property by two or more persons as joint tenants or tenants in common is not of itself to be deemed carrying on a business whether or not the owners share any profits arising from the sale thereof.

Registration by Nominee, &c.

2. Where a firm, individual, or corporation having a place of business within the United Kingdom carries on the business wholly or mainly as nominee or trustee of or for another person, or other persons, or another corporation, or acts as general agent for any foreign firm, the first-mentioned firm, individual, or corporation shall be registered in manner provided by this Act, and, in addition to the other particulars required to be furnished and registered, there shall be furnished and registered the particulars mentioned in the schedule to this Act:

Provided that where the business is carried on by a trustee in bankruptcy or a receiver or manager appointed by any Court, registration under this section shall not be necessary.

Manner and Particulars of Registration

3.—(1) Every firm or person required under this Act to be registered shall furnish by sending by post or delivering to the registrar at the register office in that part of the United Kingdom in which the principal place of business of the firm or person is situated a statement in writing in the prescribed form containing the following particulars:

- (a) The business name;
- (b) The general nature of the business;
- (c) The principal place of the business;
- (d) Where the registration to be effected is that of a firm, the present Christian name and surname, any former Christian name or surname, the nationality, and if that nationality is not the nationality of origin, the nationality of origin, the usual residence, and the other business occupation (if any) of each of the individuals who are partners, and the corporate name and registered or principal office of every corporation which is a partner;
- (e) Where the registration to be effected is that of an individual, the present Christian name and surname, any former Christian name or surname, the nationality, and if that nationality is not the nationality of origin, the nationality of origin, the usual residence, and the other business occupation (if any) of such individual;
- (f) Where the registration to be effected is that of a corporation, its corporate name and registered or principal office;
- (g) If the business is commenced after the passing of this Act, the date of the commencement of the business.

(2) Where a business is carried on under two or more business names, each of those business names must be stated.

Statements to be Signed by Persons Registering

4. The statement required for the purpose of registration must in the case of an individual be signed by him, and in the case of a corporation by a director or secretary thereof, and in the case of a firm either by all the individuals who are partners, and by a director or the secretary of all corporations which are partners or by some individual who is a partner, or a director or the secretary of some corporation which is a partner, and in either of the last two cases must be verified by a statutory declaration made by the signatory: Provided that no such statutory declaration stating that any person other than the declarant is a partner, or enutting to state that any person other than as aforesaid is a partner, shall be evidence for or against any such other person in respect of his liability or non-liability as a partner, and that the High Court or a Judge thereof may on application of any person alleged or claiming to be a partner direct the rectification of the register and decide any question arising under this section.

Time for Registration

5. The particulars required to be furnished under this Act shall be furnished within fourteen days after the firm or person commences business, or the business in respect of which registration is required, as the case may be: Provided that if such firm or person has carried on such business before the passing of this Act or commences such business within two months thereafter, the statement of particulars shall be furnished after the expiration of two months and before the expiration of three months from the passing of this Act, and that if at the expiration of the said two months the conditions affecting the firm or persons have ceased to be such as to require registration under this Act, the firm or person need not be registered so long as such conditions continue.

This section shall apply, in the case where registration is required in consequence of a change of name, as if for references to the date of the commencement of the business there were substituted references to the date of such change.

Registration of Changes in Firm

6. Whenever a change is made or occurs in any of the particulars registered in respect of any firm or person such firm or person shall, within fourteen days after such change, or such longer period as the Board of Trade may, on application being made in any particular case, whether before or after the expiration of such fourteen days, allow, furnish by sending by post or delivery to the registrar in that part of the United Kingdom in which the aforesaid particulars are registered a statement in writing in the prescribed form specifying the nature and date of the change signed, and where necessary verified, in like manner as the statement required on registration.

Penalty for Default in Registration

7. If any firm or person by this Act required to furnish a statement of particulars or of any change in particulars shall without reasonable excuse make default in so doing in the manner and within the time specified by this Act, every partner in the firm or the person so in default shall be liable on summary conviction to a fine not exceeding five pounds for every day during which the default continues, and the Court shall order a statement of the required particulars or change in the particulars to be furnished to the registrar within such time as may be specified in the order.

Disability of Person in Default

8.—(1) Where any firm or person by this Act required to furnish a statement of particulars or of any change in particulars shall have made default in so doing, then the rights of that defaulter under or arising out of any contract made or entered into by or on behalf of such defaulter in relation to the business in respect of the carrying on of which particulars were required to be furnished at any time while he is in default shall not be enforceable by action or other legal proceeding either in the business name or otherwise:

Provided always as follows:

(a) The defaulter may apply to the Court for relief against the disability im-

posed by this section, and the Court, on being satisfied that the default was accidental, or due to inadvertence, or some other sufficient cause, or that on other grounds it is just and equitable to grant relief, may grant such relief either generally, or as respects any particular contracts, on condition of the costs of the application being paid by the defaulter, unless the Court otherwise orders, and on such other conditions (if any) as the Court may impose, but such relief shall not be granted except on such service and such publication of notice of the application as the Court may order, nor shall relief be given in respect of any contract if any party to the contract proves to the satisfaction of the Court that, if this Act had been complied with, he would not have entered into the contract;

- (b) Nothing herein contained shall prejudice the rights of any other parties as against the defaulters in respect of such contract as aforesaid;
 - (c) If any action or proceeding shall be commenced by any other party against the defaulter to enforce the rights of such party in respect of such contract, nothing herein contained shall preclude the defaulter from enforcing in that action or proceeding, by way of counterclaim set off or otherwise, such rights as he may have against that party in respect of such contract.
- (2) In this section the expression 'Court' means the 'High Court' or a Judge thereof:

Provided that, without prejudice to the power of the High Court or a Judge thereof to grant such relief as aforesaid, if any proceeding to enforce any contract is commenced by a defaulter in a County Court, the County Court may, as respects that contract, grant such relief as aforesaid.

Penalty for False Statements

9. If any statement required to be furnished under this Act contains any matter which is false in any material particular to the knowledge of any person signing it, that person shall, on summary conviction, be liable to imprisonment with or without hard labour for a term not exceeding three months, or to a fine not exceeding twenty pounds, or to both such imprisonment and fine.

Duty to Furnish Particulars to Board of Trade

10.—(1) The Board of Trade may require any person to furnish to the Board such particulars as appear necessary to the Board for the purpose of ascertaining whether or not he or the firm of which he is partner should be registered under this Act, or an alteration made in the registered particulars, and may also in the case of a corporation require the secretary or any other officer of a corporation performing the duties of secretary to furnish such particulars, and if any person when so required fails to supply such particulars as it is in his power to give, or furnishes particulars which are false in any material particular, he shall on summary conviction be liable to imprisonment with or without hard labour for a term not exceeding three months, or to a fine not exceeding twenty pounds, or to both such imprisonment and fine.

(2) If from any information so furnished it appears to the Board of Trade that any firm or person ought to be registered under this Act, or an alteration ought to be made in the registered particulars, the Board may require the firm or person to furnish to the registrar the required particulars within such time as may be allowed by the Board, but where any default under this Act has been discovered from the information acquired under this section no proceedings under this Act shall be taken against any person in respect of such default prior to the expiration of the time within which the firm or person is required by the Board under this section to furnish particulars to the registrar.

Registrar to file Statement and issue Certificate of Registration

11. On receiving any statement or statutory declaration made in pursuance of this Act the registrar shall cause the same to be filed, and he shall send by post or deliver a certificate of the registration thereof to the firm or person registering and the certificate or a certified copy thereof shall be kept exhibited in a conspicuous position at the principal place of business of the firm or individual, and if not kept so exhibited, every partner in the firm or the person, as the case may be, shall be liable on summary conviction to a fine not exceeding twenty pounds.

Index to be Kept

12. At each of the register offices hereinafter referred to the registrar shall keep an index of all the firms and persons registered at that office under this Act.

Removal of Names from Register

13.—(1) If any firm or individual registered under this Act ceases to carry on business, it shall be the duty of the persons who were partners in the firm at the time when it ceased to carry on business or of the individual or if he is dead his personal representative, within three months after the business has ceased to be carried on, to send by post or deliver to the registrar notice in the prescribed form that the firm or individual has ceased to carry on business, and if any person whose duty it is to give such notice fails to do so within such time as aforesaid, he shall be liable on summary conviction to a fine not exceeding twenty pounds.

(2) On receipt of such a notice as aforesaid the registrar may remove the firm or individual from the register.

(3) Where the registrar has reasonable cause to believe that any firm or individual registered under this Act is not carrying on business he may send to the firm or individual by registered post a notice that, unless an answer is received to such notice within one month from the date thereof, the firm or individual may be removed from the register.

(4) If the registrar either receives an answer from the firm or individual to the effect that the firm or individual is not carrying on business or does not within one month after sending the notice receive an answer, he may remove the firm or individual from the register.

Publication of True Names, &c.

18.—(1) After the expiration of three months from the passing of this Act every individual and firm required by this Act to be registered shall, in all trade catalogues, trade circulars, showcards and business letters, on or in which the business name appears and which are issued or sent by the individual or firm to any person in any part of his Majesty's dominions, have mentioned in legible characters—

(a) in the case of an individual his present Christian name or the initials thereof and present surname, any former Christian name or surname, his nationality if not British, and if his nationality is not his nationality of origin his nationality of origin; and

(b) in the case of a firm, the present Christian names or the initials thereof and present surnames, any former Christian names and surnames, and the nationality if not British, and if the nationality is not the nationality of origin the nationality of origin of all the partners in the firm or, in the case of a corporation being a partner, the corporate name.

(2) If default is made in compliance with this section the individual or, as the case may be, every member of the firm shall be liable on summary conviction for each offence to a fine not exceeding five pounds:

Provided that no proceedings shall in England or Ireland be instituted under this section except by or with the consent of the Board of Trade.

SCHEDULE

Description of Firm, &c.	The additional Particulars.
Where the firm, individual, or corporation required to be registered carries on business as nominee or trustee.	The present Christian name and surname, any former name, nationality and, if that nationality is not the nationality of origin, the nationality of origin, and usual residence, or, as the case may be, the corporate name, of every person or corporation on whose behalf the business is carried on. Provided that if the business is carried on under any trust and any of the beneficiaries are a class of children or other persons, a description of the class shall be sufficient.
Where the firm, individual, or corporation required to be registered carries on business as general agent for any foreign firm.	The business name and address of the firm or person as agent for whom the business is carried on: Provided that if the business is carried on as agent for three or more foreign firms it shall be sufficient to state the fact that the business is so carried on, specifying the countries in which such foreign firms carry on business.

THE COMPANIES ACT, 1947

10 & 11 *Geo. 6 Ch. 47*

(AMENDMENTS TO REGISTRATION OF BUSINESS NAMES ACT, 1946)

58.—(1) In Section 1 of the Registration of Business Names Act, 1916 (which requires registration under that Act of all individuals and firms carrying on business under a business name), there shall be inserted after paragraph (c) thereof the following paragraph:

‘(d) every company as defined in the Companies Act, 1929, carrying on business under a business name which does not consist of its corporate name without any addition;’.

(2) Subsection (1) of Section 3 (which relates to the particulars to be registered), and the proviso to Section 5 (which relates to the time for registration), of the first-mentioned Act shall apply in relation to registration by virtue of this section as if references therein to the passing of that Act were references to the coming into force of this section.

(3) Section 13 of that Act (which relates to the removal of names from the register where a firm or individual ceases to carry on business) shall apply in relation to a company registered under that Act by virtue of this section, which ceases to carry on business in such circumstances as to require registration thereunder, as it applies in relation to a firm which ceases to carry on business, but with the substitution for the reference to the partners in the firm of a reference to the directors and any liquidator of the company.

NINTH SCHEDULE

PART II

ENACTMENTS OF REGISTRATION OF BUSINESS NAMES ACT, 1916, REPEALED

In subsection (1) of Section 3, the words ‘and if that nationality is not the nationality of origin, the nationality of origin’, in both places where they occur.

In subsection (1) of Section 18, the words ‘and if his nationality is not his nationality of origin his nationality of origin’ in paragraph (a), and the words ‘and if the nationality is not the nationality of origin, the nationality of origin’ in paragraph (b).

In Section 22, in the definition of a former Christian name or surname, the words from the first ‘shall not’, to ‘and’, and in the definition of a change of name the words from the first ‘in the case of’, to the first ‘or’.

In the Schedule, the words ‘and if that nationality is not the nationality of origin, the nationality of origin’.

THE COMPANIES ACT, 1948

11 & 12 *Geo. 6, Ch. 38*

37. A prospectus issued by or on behalf of a company or in relation to an intended company shall be dated, and that date shall, unless the contrary is proved, be taken as the date of publication of the prospectus.

39.—(1) Where—

(a) it is proposed to offer any shares in or debentures of a company to the public by a prospectus issued generally (that is to say, issued to persons who are not existing members or debenture holders of the company); and

(b) application is made to a prescribed stock exchange for permission for those shares or debentures to be dealt in or quoted on that stock exchange; there may, on the request of the applicant, be given by or on behalf of that stock exchange a certificate of exemption, that is to say, a certificate that, having regard to the proposals (as stated in the request) as to the size and other circumstances of the issue of shares or debentures and as to any limitations on the number and class of persons to whom the offer is to be made, compliance with the requirements of the Fourth Schedule to this Act would be unduly burdensome.

(2) If a certificate of exemption is given, and if the proposals aforesaid are delivered to and the particulars and information required to be published in connection with the application for permission made to the stock exchange are so published, then—

- (a) a prospectus giving the particulars and information aforesaid in the form in which they are so required to be published shall be deemed to comply with the requirements of the Fourth Schedule to this Act; and
- (b) the last foregoing section shall not apply to any issue after the permission applied for is granted, of a prospectus or form of application relating to the shares or debentures.

40.—(1) A prospectus inviting persons to subscribe for shares in or debentures of a company and including a statement purporting to be made by an expert shall not be issued unless—

- (a) he has given and has not, before delivery of a copy of the prospectus for registration, withdrawn his written consent to the issue thereof with the statement included in the form and context in which it is included, and
- (b) a statement that he has given and has not withdrawn his consent as aforesaid appears in the prospectus.

(2) If any prospectus is issued in contravention of this section the company and every person who is knowingly a party to the issue thereof shall be liable to a fine not exceeding five hundred pounds.

(3) In this section the expression 'expert' includes engineer, valuer, accountant and any other person whose profession gives authority to a statement made by him.

41.—(1) No prospectus shall be issued by or on behalf of a company or in relation to an intended company unless, on or before the date of its publication, there has been delivered to the registrar of companies for registration a copy thereof signed by every person who is named therein as a director or proposed director of the company, or by his agent authorised in writing, and having endorsed thereon or attached thereto—

- (a) any consent to the issue of the prospectus required by the last foregoing section from any person as an expert, and
- (b) in the case of a prospectus issued generally, also—
 - (i) a copy of any contract required by paragraph 14 of the Fourth Schedule to this Act to be stated in the prospectus or, in the case of a contract not reduced into writing, a memorandum giving full particulars thereof or, if in the case of a prospectus deemed by virtue of a certificate granted under Section 39 of this Act to comply with the requirements of that Schedule a contract or a copy thereof or a memorandum of a contract is required to be available for inspection in connection with the application made under that section to the stock exchange, a copy or, as the case may be, a memorandum of that contract; and
 - (ii) where the persons making any report required by Part II of that Schedule have made therein, or have, without giving the reasons, indicated therein, any such adjustments as are mentioned in paragraph 29 of that Schedule, a written statement signed by those persons setting out the adjustments and giving the reasons therefor.

The references in sub-paragraph (i) of paragraph (b) of this subsection to the copy of a contract required thereby to be endorsed on or attached to a copy of the prospectus shall, in the case of a contract wholly or partly in a foreign language, be taken as references to a copy of a translation of the contract in English or a copy embodying a translation in English of the parts in a foreign language, as the case may be, being a translation certified in the prescribed manner to be a correct translation, and the reference to a copy of a contract required to be available for inspection shall include a reference to a copy of a translation thereof or a copy embodying a translation of parts thereof.

(2) Every prospectus shall, on the face of it—

- (a) state that a copy has been delivered for registration as required by this section; and

- (b) specify, or refer to statements included in the prospectus which specify, any documents required by this section to be endorsed on or attached to the copy so delivered.

(3) The Registrar shall not register a prospectus unless it is dated and the copy thereof signed in manner required by this section and unless it has endorsed thereon or attached thereto the documents (if any) specified as aforesaid.

(4) If a prospectus is issued without a copy thereof being delivered under this section to the Registrar or without the copy so delivered having endorsed thereon or attached thereto the required documents, the company, and every person who is knowingly a party to the issue of the prospectus, shall be liable to a fine not exceeding five pounds for every day from the date of the issue of the prospectus until a copy thereof is so delivered with the required documents endorsed thereon or attached thereto.

43.—(1) Subject to the provisions of this section, where a prospectus invites persons to subscribe for shares in or debentures of a company, the following persons shall be liable to pay compensation to all persons who subscribe for any shares or debentures on the faith of the prospectus for the loss or damage they may have sustained by reason of any untrue statement included therein, that is to say:

- (a) every person who is a director of the company at the time of the issue of the prospectus;
- (b) every person who has authorised himself to be named and is named in the prospectus as a director or as having agreed to become a director either immediately or after an interval of time;
- (c) every person being a promoter of the company; and
- (d) every person who has authorised the issue of the prospectus:

Provided that where, under Section 40 of this Act, the consent of a person is required to the issue of a prospectus and he has given that consent, he shall not by reason of his having given it be liable under this subsection as a person who has authorised the issue of the prospectus except in respect of an untrue statement purporting to be made by him as an expert.

(2) No person shall be liable under subsection (1) of this section if he proves—

- (a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or
- (b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue he forthwith gave reasonable public notice that it was issued without his knowledge or consent; or
- (c) that, after the issue of the prospectus and before allotment thereunder, he, on becoming aware of any untrue statement therein, withdrew his consent thereto and gave reasonable public notice of the withdrawal and of the reason therefor; or
- (d) that—

- (i) as regards every untrue statement not purporting to be made on the authority of an expert or of a public official document or statement, he had reasonable ground to believe, and did up to the time of the allotment of the shares or debentures, as the case may be, believe, that the statement was true; and
- (ii) as regards every untrue statement purporting to be a statement by an expert or contained in what purports to be a copy of or extract from a report or valuation of an expert, it fairly represented the statement, or was a correct and fair copy of or extract from the report or valuation, and he had reasonable ground to believe and did up to the time of the issue of the prospectus believe that the person making the statement was competent to make it and that person had given the consent required by Section 40 of this Act to the issue of the prospectus and had not withdrawn that consent before delivery of a copy of the prospectus for registration or, to the defendant's knowledge, before allotment thereunder; and

- (iii) as regards every untrue statement purporting to be a statement made by an official person or contained in what purports to be a copy of or extract from a public official document, it was a correct and fair representation of the statement or copy of or extract from the document:

Provided that this subsection shall not apply in the case of a person liable, by reason of his having given a consent required of him by the said Section 40, as a person who has authorised the issue of the prospectus in respect of an untrue statement purporting to be made by him as an expert.

(3) A person who, apart from this subsection would under subsection (1) of this section be liable, by reason of his having given a consent required of him by Section 40 of this Act, as a person who has authorised the issue of a prospectus in respect of an untrue statement purporting to be made by him as an expert shall not be so liable if he proves—

- (a) that, having given his consent under the said Section 40 to the issue of the prospectus, he withdrew it in writing before delivery of a copy of the prospectus for registration, or
 - (b) that, after delivery of a copy of the prospectus for registration and before allotment thereunder, he, on becoming aware of the untrue statement, withdrew his consent in writing and gave reasonable public notice of the withdrawal, and of the reason therefor, or
 - (c) that he was competent to make the statement and that he had reasonable ground to believe and did up to the time of the allotment of the shares or debentures, as the case may be, believe that the statement was true.
- (4) Where—
- (a) the prospectus contains the name of a person as a director of the company, or as having agreed to become a director thereof, and he has not consented to become a director, or has withdrawn his consent before the issue of the prospectus, and has not authorised or consented to the issue thereof; or
 - (b) the consent of a person is required under Section 40 of this Act to the issue of the prospectus and he either has not given that consent or has withdrawn it before the issue of the prospectus;

the directors of the company, except any without whose knowledge or consent the prospectus was issued, and any other person who authorised the issue thereof shall be liable to indemnify the person named as aforesaid or whose consent was required as aforesaid, as the case may be, against all damages, costs and expenses to which he may be made liable by reason of his name having been inserted in the prospectus or of the inclusion therein of a statement purporting to be made by him as an expert, as the case may be, or in defending himself against any action or legal proceeding brought against him in respect thereof:

Provided that a person shall not be deemed for the purposes of this subsection to have authorised the issue of a prospectus by reason only of his having given the consent required by Section 40 of this Act to the inclusion therein of a statement purporting to be made by him as an expert.

(5) For the purposes of this section—

- (a) the expression 'promoter' means a promoter who was a party to the preparation of the prospectus, or of the portion thereof containing the untrue statement, but does not include any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company; and
- (b) the expression 'expert' has the same meaning as in Section 40 of this Act.

44.—(1) Where a prospectus issued after the commencement of this Act includes any untrue statement, any person who authorised the issue of the prospectus shall be liable—

- (a) on conviction on indictment, to imprisonment for a term not exceeding two years, or a fine not exceeding five hundred pounds, or both; or
- (b) on summary conviction, to imprisonment for a term not exceeding three months, or a fine not exceeding one hundred pounds, or both:

unless he proves either that the statement was immaterial or that he had

reasonable ground to believe and did, up to the time of the issue of the prospectus, believe that the statement was true.

(2) A person shall not be deemed for the purposes of this section to have authorised the issue of a prospectus by reason only of his having given the consent required by Section 40 of this Act to the inclusion therein of a statement purporting to be made by him as an expert.

46. For the purposes of the foregoing provisions of this Part of this Act—

- (a) a statement included in a prospectus shall be deemed to be untrue if it is misleading in the form and context in which it is included; and
- (b) a statement shall be deemed to be included in a prospectus if it is contained therein or in any report or memorandum appearing on the face thereof or by reference incorporated therein or issued therewith.

Allotment

47.—(1) No allotment shall be made of any share capital of a company offered to the public for subscription unless the amount stated in the prospectus as the minimum amount which, in the opinion of the directors, must be raised by the issue of share capital in order to provide for the matters specified in paragraph 4 of the Fourth Schedule to this Act has been subscribed, and the sum payable on application for the amount so stated has been paid to and received by the company.

For the purposes of this subsection, a sum shall be deemed to have been paid to and received by the company if a cheque for that sum has been received in good faith by the company and the directors of the company have no reason for suspecting that the cheque will not be paid.

(2) The amount so stated in the prospectus shall be reckoned exclusively of any amount payable otherwise than in cash and is in this Act referred to as 'the minimum subscription'.

(3) The amount payable on application on each share shall not be less than 5 per cent. of the nominal amount of the share.

(4) If the conditions aforesaid have not been complied with on the expiration of forty days after the first issue of the prospectus, all money received from applicants for shares shall be forthwith repaid to them without interest, and, if any such money is not so repaid within forty-eight days after the issue of the prospectus, the directors of the company shall be jointly and severally liable to repay that money with interest at the rate of 5 per cent. per annum from the expiration of the forty-eighth day:

Provided that a director shall not be liable if he proves that the default in the repayment of the money was not due to any misconduct or negligence on his part.

(5) Any condition requiring or binding any applicant for shares to waive compliance with any requirement of this section shall be void.

(6) This section, except subsection (3) thereof, shall not apply to any allotment of shares subsequent to the first allotment of shares offered to the public for subscription.

53.—(1) It shall be lawful for a company to pay a commission to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company if—

- (a) the payment of the commission is authorised by the articles; and
- (b) the commission paid or agreed to be paid does not exceed 10 per cent. of the price at which the shares are issued or the amount or rate authorised by the articles, whichever is the less; and
- (c) the amount or rate per cent. of the commission paid or agreed to be paid is—
 - (i) in the case of shares offered to the public for subscription, disclosed in the prospectus; or
 - (ii) in the case of shares not offered to the public for subscription, disclosed in the statement in lieu of prospectus, or in a statement in the prescribed form signed in like manner as a statement in lieu of prospectus and delivered before the payment of the commission to the registrar of

companies for registration, and, where a circular or notice, not being a prospectus, inviting subscription for the shares is issued, also disclosed in that circular or notice; and

(d) the number of shares which persons have agreed for a commission to subscribe absolutely is disclosed in manner aforesaid.

(2) Save as aforesaid, no company shall apply any of its shares or capital money either directly or indirectly in payment of any commission, discount or allowance to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company, whether the shares or money be so applied by being added to the purchase money of any property acquired by the company or to the contract price of any work to be executed for the company, or the money be paid out of the nominal purchase money or contract price, or otherwise.

(3) Nothing in this section shall affect the power of any company to pay such brokerage as it has heretofore been lawful for a company to pay.

(4) A vendor to, promoter of, or other person who receives payment in money or shares from, a company shall have and shall be deemed always to have had power to apply any part of the money or shares so received in payment of any commission, the payment of which, if made directly by the company, would have been legal under this section.

(5) If default is made in complying with the provisions of this section relating to the delivery to the registrar of the statement in the prescribed form, the company and every officer of the company who is in default shall be liable to a fine not exceeding twenty-five pounds.

(6) Nothing in this section shall affect the operation of subsection (2) of Section 3 of the Gas Undertakings Act, 1934 (which limits the rate at which commission may be paid by gas undertakers).

54.—(1) Subject as provided in this section, it shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company, or, where the company is a subsidiary company, in its holding company:

Provided that nothing in this section shall be taken to prohibit—

- (a) where the lending of money is part of the ordinary business of a company, the lending of money by the company in the ordinary course of its business;
- (b) the provision by a company, in accordance with any scheme for the time being in force, of money for the purchase of, or subscription for, fully-paid shares in the company or its holding company, being a purchase or subscription by trustees of or for shares to be held by or for the benefit of employees of the company, including any director holding a salaried employment or office in the company;
- (c) the making by a company of loans to persons, other than directors, bona fide in the employment of the company with a view to enabling those persons to purchase or subscribe for fully-paid shares in the company or its holding company to be held by themselves by way of beneficial ownership.

(2) If a company acts in contravention of this section, the company and every officer of the company who is in default shall be liable to a fine not exceeding one hundred pounds.

56.—(1) Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account, to be called 'the share premium account', and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the share premium account were paid-up share capital of the company.

(2) The share premium account may, notwithstanding anything in the foregoing subsection, be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully-paid bonus shares, in writing off—

(a) the preliminary expenses of the company; or
 (b) the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
 or in providing for the premium payable on redemption of any redeemable preference shares or of any debentures of the company.

(3) Where a company has before the commencement of this Act issued any shares at a premium, this section shall apply as if the shares had been issued after the commencement of this Act:

Provided that any part of the premiums which has been so applied that it does not at the commencement of this Act form an identifiable part of the company's reserves within the meaning of the Eighth Schedule to this Act shall be disregarded in determining the sum to be included in the share premium account.

57.—(1) Subject as provided in this section, it shall be lawful for a company to issue at a discount shares in the company of a class already issued:

Provided that—

- (a) the issue of the shares at a discount must be authorised by resolution passed in general meeting of the company, and must be sanctioned by the Court;
- (b) the resolution must specify the maximum rate of discount at which the shares are to be issued;
- (c) not less than one year must at the date of the issue have elapsed since the date on which the company was entitled to commence business;
- (d) the shares to be issued at a discount must be issued within one month after the date on which the issue is sanctioned by the Court or within such extended time as the Court may allow.

(2) Where a company has passed a resolution authorising the issue of shares at a discount, it may apply to the Court for an order sanctioning the issue, and on any such application the Court, if, having regard to all the circumstances of the case, it thinks proper so to do, may make an order sanctioning the issue on such terms and conditions as it thinks fit.

(3) Every prospectus relating to the issue of the shares must contain particulars of the discount allowed on the issue of the shares or of so much of that discount as has not been written off at the date of the issue of the prospectus.

If default is made in complying with this subsection, the company and every officer of the company who is in default shall be liable to a default fine.

58.—(1) Subject to the provisions of this section, a company limited by shares may, if so authorised by its articles, issue preference shares which are, or at the option of the company are to be liable, to be redeemed:

Provided that—

- (a) no such shares shall be redeemed except out of profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of the redemption;
- (b) no such shares shall be redeemed unless they are fully paid;
- (c) the premium, if any, payable on redemption, must have been provided for out of the profits of the company or out of the company's share premium account before the shares are redeemed;
- (d) where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend be transferred to a reserve fund, to be called 'the capital redemption reserve fund', a sum equal to the nominal amount of the shares redeemed, and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the capital redemption reserve fund were paid-up share capital of the company.

(2) Subject to the provisions of this section, the redemption of preference shares thereunder may be effected on such terms and in such manner as may be provided by the articles of the company.

(3) The redemption of preference shares under this section by a company shall not be taken as reducing the amount of the company's authorised share capital.

(4) Where in pursuance of this section a company has redeemed or is about to redeem any preference shares, it shall have power to issue shares up to the nominal amount of the shares redeemed or to be redeemed as if those shares had never been issued, and accordingly the share capital of the company shall not for the purposes of any enactments relating to stamp duty be deemed to be increased by the issue of shares in pursuance of this subsection:

Provided that, where new shares are issued before the redemption of the old shares, the new shares shall not, so far as relates to stamp duty, be deemed to have been issued in pursuance of this subsection unless the old shares are redeemed within one month after the issue of the new shares.

(5) The capital redemption reserve fund may, notwithstanding anything in this section, be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully-paid bonus shares.

65.—(1) Where any shares of a company are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of that share capital as is for the time being paid up for the period and subject to the conditions and restrictions in this section mentioned, and may charge the sum so paid by way of interest to capital as part of the cost of construction of the work or building, or the provision of plant:

Provided that—

- (a) no such payment shall be made unless it is authorised by the articles or by special resolution;
- (b) no such payment, whether authorised by the articles or by special resolution, shall be made without the previous sanction of the Board of Trade;
- (c) before sanctioning any such payment the Board of Trade may, at the expense of the company, appoint a person to inquire and report to them as to the circumstances of the case, and may, before making the appointment, require the company to give security for the payment of the costs of the inquiry;
- (d) the payment shall be made only for such period as may be determined by the Board of Trade, and that period shall in no case extend beyond the close of the half year next after the half year during which the works or buildings have been actually completed or the plant provided;
- (e) the rate of interest shall in no case exceed 4 per cent. per annum or such other rate as may for the time being be prescribed by order of the Treasury;
- (f) the payment of the interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid;
- (g) nothing in this section shall affect any company to which the Indian Railways Act, 1894, as amended by any subsequent enactment, applies.

(2) The power conferred by this section on the Treasury shall be exercisable by statutory instrument which shall be subject to annulment in pursuance of a resolution of either House of Parliament.

78.—(1) If a company refuses to register a transfer of any shares or debentures, the company shall, within two months after the date on which the transfer was lodged with the company, send to the transferee notice of the refusal.

(2) If default is made in complying with this section, the company and every officer of the company who is in default shall be liable to a default fine.

79.—(1) The certification by a company of any instrument of transfer of shares in or debentures of the company shall be taken as a representation by the company to any person acting on the faith of the certification that there have been produced to the company such documents as on the face of them show a prima facie title to the shares or debentures in the transferor named in the instrument of transfer, but not as a representation that the transferor has any title to the shares or debentures.

(2) Where any person acts on the faith of a false certification by a company made negligently, the company shall be under the same liability to him as if the certification had been made fraudulently.

(3) For the purposes of this section—

- (a) an instrument of transfer shall be deemed to be certificated if it bears the words 'certificate lodged' or words to the like effect;
- (b) the certification of an instrument of transfer shall be deemed to be made by a company if—
 - (i) the person issuing the instrument is a person authorised to issue certificated instruments of transfer on the company's behalf; and
 - (ii) the certification is signed by a person authorised to certificate transfers on the company's behalf or by any officer or servant either of the company or of a body corporate so authorised;
- (c) a certification shall be deemed to be signed by any person if—
 - (i) it purports to be authenticated by his signature or initials (whether handwritten or not); and
 - (ii) it is not shown that the signature or initials was or were placed there neither by himself nor by any person authorised to use the signature or initials for the purpose of certifying transfers on the company's behalf.

80.—(1) Every company shall, within two months after the allotment of any of its shares, debentures or debenture stock and within two months after the date on which a transfer of any such shares, debentures or debenture stock is lodged with the company, complete and have ready for delivery the certificates of all shares, the debentures and the certificates of all debenture stock allotted or transferred, unless the conditions of issue of the shares, debentures or debenture stock otherwise provide.

The expression 'transfer' for the purpose of this subsection means a transfer duly stamped and otherwise valid, and does not include such a transfer as the company is for any reason entitled to refuse to register and does not register.

(2) If default is made in complying with this section, the company and every officer of the company who is in default shall be liable to a default fine.

(3) If any company on whom a notice has been served requiring the company to make good any default in complying with the provisions of subsection (1) of this section fails to make good the default within ten days after the service of the notice, the Court may, on the application of the person entitled to have the certificates or the debentures delivered to him, make an order directing the company and any officer of the company to make good the default within such time as may be specified in the order, and any such order may provide that all costs of and incidental to the application shall be borne by the company or by any officer of the company responsible for the default.

86.—(1) A company registered in England shall not keep in Scotland and a company registered in Scotland shall not keep in England any register of holders of debentures of the company or any duplicate of any such register or part of any such register which is kept outside Great Britain.

(2) Neither a register of holders of debentures of a company nor a duplicate of any such register or part of any such register which is kept outside Great Britain shall be kept in England, in the case of a company registered in England, or in Scotland, in the case of a company registered in Scotland, elsewhere than at the registered office of the company, any other office of the company at which the work of making it up is done, or, if the company arranges with some other person for the making up of the register or duplicate to be undertaken on behalf of the company by that other person, at the office of that other person at which the work is done, and where a company keeps in England or Scotland, as the case may be, both such a register and such a duplicate, it shall keep them at the same place.

(3) Every company which keeps any such register or duplicate in England or Scotland shall send notice to the registrar of companies of the place where the register or duplicate is kept and of any change in that place:

Provided that a company shall not be bound to send notice under this subsection where the register or duplicate has, at all times since it came into existence, or in the case of a company which came into existence after the commencement of this Act, at all times since then, been kept at the registered office of the company.

96.—(1) It shall be the duty of a company to send to the registrar of companies for registration the particulars of every charge created by the company and of

the issues of debentures of a series requiring registration under the last foregoing section, but registration of any such charge may be effected on the application of any person interested therein.

(2) Where registration is effected on the application of some person other than the company, that person shall be entitled to recover from the company the amount of any fees properly paid by him to the registrar on the registration.

(3) If any company makes default in sending to the registrar for registration the particulars of any charge created by the company or of the issues of debentures of a series requiring registration as aforesaid, then, unless the registration has been effected on the application of some other person, the company and every officer of the company who is in default shall be liable to a default fine of fifty pounds.

104.—(1) Every limited company shall keep at the registered office of the company a register of charges and enter therein all charges specifically affecting property of the company and all floating charges on the undertaking or any property of the company, giving in each case a short description of the property charged, the amount of the charge, and, except in the case of securities to bearer, the names of the persons entitled thereto.

(2) If any officer of the company knowingly and wilfully authorises or permits the omission of any entry required to be made in pursuance of this section, he shall be liable to a fine not exceeding fifty pounds.

105.—(1) The copies of instruments creating any charge requiring registration under this Part of this Act with the registrar of companies, and the register of charges kept in pursuance of the last foregoing section, shall be open during business hours (but subject to such reasonable restrictions as the company in general meeting may impose, so that not less than two hours in each day shall be allowed for inspection) to the inspection of any creditor or member of the company without fee, and the register of charges shall also be open to the inspection of any other person on payment of such fee, not exceeding one shilling for each inspection, as the company may prescribe.

(2) If inspection of the said copies or register is refused, every officer of the company who is in default shall be liable to a fine not exceeding five pounds and a further fine not exceeding two pounds for every day during which the refusal continues.

(3) If any such refusal occurs in relation to a company registered in England, the Court may by order compel an immediate inspection of the copies or register.

110.—(1) Every company shall keep a register of its members and enter therein the following particulars:

- (a) the names and addresses of the members, and in the case of a company having a share capital a statement of the shares held by each member, distinguishing each share by its number so long as the share has a number, and of the amount paid or agreed to be considered as paid on the shares of each member;
- (b) the date at which each person was entered in the register as a member;
- (c) the date at which any person ceased to be a member:

Provided that, where the company has converted any of its shares into stock and given notice of the conversion to the registrar of companies, the register shall show the amount of stock held by each member instead of the amount of shares and the particulars relating to shares specified in paragraph (a) of this subsection.

(2) The register of members shall be kept at the registered office of the company: Provided that—

- (a) if the work of making it up is done at another office of the company, it may be kept at that other office; and
- (b) if the company arranges with some other person for the making up of the register to be undertaken on behalf of the company by that other person, it may be kept at the office of that other person at which the work is done;

so, however, that it shall not be kept, in the case of a company registered in

England, at a place outside England, and, in the case of a company registered in Scotland, at a place outside Scotland.

(3) Every company shall send notice to the registrar of companies of the place where its register of members is kept and of any change in that place;

Provided that a company shall not be bound to send notice under this subsection where the register has, at all times since it came into existence or, in the case of a register in existence at the commencement of this Act, at all times since then, been kept at the registered office of the company.

(4) Where a company makes default in complying with subsection (1) of this section or makes default for fourteen days in complying with the last foregoing subsection, the company and every officer of the company who is in default shall be liable to a default fine.

111.—(1) Every company having more than fifty members shall, unless the register of members is in such a form as to constitute in itself an index, keep an index of the names of the members of the company and shall, within fourteen days after the date on which any alteration is made in the register of members, make any necessary alteration in the index.

(2) The index shall in respect of each member contain a sufficient indication to enable the account of that member in the register to be readily found.

(3) The index shall be at all times kept at the same place as the register of members.

(4) If default is made in complying with this section, the company and every officer of the company who is in default shall be liable to a default fine.

124.—(1) Every company having a share capital shall, once at least in every year, make a return containing with respect to the registered office of the company, registers of members and debenture holders, shares and debentures, indebtedness, past and present members and directors and secretary, the matters specified in Part I of the Sixth Schedule to this Act, and the said return shall be in the form set out in Part II of that Schedule or as near thereto as circumstances admit:

Provided that—

- (a) a company need not make a return under this subsection either in the year of its incorporation or, if it is not required by Section 131 of this Act to hold an annual general meeting during the following year, in that year;
 - (b) where the company has converted any of its shares into stock and given notice of the conversion to the registrar of companies, the list referred to in paragraph 5 of Part I of the said Sixth Schedule must state the amount of stock held by each of the existing members instead of the amount of shares and the particulars relating to shares required by that paragraph;
 - (c) the return may, in any year, if the return for either of the two immediately preceding years has given as at the date of that return the full particulars required by the said paragraph 5, give only such of the particulars required by that paragraph as relate to persons ceasing to be or becoming members since the date of the last return and to shares transferred since that date or to changes as compared with that date in the amount of stock held by a member; and
 - (d) the annual return of a company made next after the expiry of paragraph (1) of regulation 3 of the Defence (Companies) Regulations, 1940 (under which the annual return of a company having a share capital need not contain any list of members, except in the case of a company's first annual return or of a private company), need not, if that paragraph applied to the annual return last made by the company, give the particulars required by the said paragraph 5 as to past members of the company or as to shares transferred.
- (2) In the case of a company keeping a dominion register—
- (a) references in proviso (c) to the foregoing subsection to the particulars required by the said paragraph 5 shall be taken as not including any such particulars contained in the dominion register, in so far as copies of the

entries containing those particulars are not received at the registered office of the company before the date when the return in question is made; and

- (b) where an annual return is made between the date when any entries are made in the dominion register and the date when copies of those entries are received at the registered office of the company, the particulars contained in those entries, so far as relevant to an annual return, shall be included in the next or a subsequent annual return as may be appropriate having regard to the particulars included in that return with respect to the company's register of members.

(3) If a company fails to comply with this section, the company and every officer of the company who is in default shall be liable to a default fine.

(4) For the purposes of this section and of Part I of the Sixth Schedule to this Act the expressions 'director' and 'officer' shall include any person in accordance with whose directions or instructions the directors of the company are accustomed to act.

125.—(1) Every company not having a share capital shall once at least in every calendar year make a return stating—

- (a) the address of the registered office of the company;
- (b) in a case in which the register of members is, under the provisions of this Act, kept elsewhere than at that office, the address of the place where it is kept;
- (c) in a case in which any register of holders of debentures of the company or any duplicate of any such register or part of any such register is, under the provisions of this Act, kept, in England in the case of a company registered in England or in Scotland in the case of a company registered in Scotland, elsewhere than at the registered office of the company, the address of the place where it is kept;
- (d) all such particulars with respect to the persons who at the date of the return are the directors of the company and any person who at that date is secretary of the company as are by this Act required to be contained with respect to directors and the secretary respectively in the register of directors and secretaries of a company:

Provided that a company need not make a return under this subsection either in the year of its incorporation or, if it is not required by Section 131 of this Act to hold an annual general meeting during the following year, in that year.

(2) There shall be annexed to the return a statement containing particulars of the total amount of the indebtedness of the company in respect of all mortgages and charges which are required (or, in the case of a company registered in Scotland, which, if the company had been registered in England, would be required) to be registered with the registrar of companies under this Act, or which would have been required so to be registered if created after the first day of July, 1908.

(3) If a company fails to comply with this section, the company and every officer of the company who is in default shall be liable to a default fine.

(4) For the purposes of this section the expressions 'officer' and 'director' shall include any person in accordance with whose directions or instructions the directors of the company are accustomed to act.

126.—(1) The annual return must be completed within forty-two days after the annual general meeting for the year, whether or not that meeting is the first or only ordinary general meeting, or the first or only general meeting of the company in the year, and the company must forthwith forward to the registrar of companies a copy signed both by a director and by the secretary of the company.

(2) If a company fails to comply with this section, the company and every officer of the company who is in default shall be liable to a default fine.

For the purposes of this subsection the expression 'officer' shall include any person in accordance with whose directions or instructions the directors of the company are accustomed to act.

127.—(1) Subject to the provisions of this Act, there shall be annexed to the annual return—

- (a) a written copy, certified both by a director and by the secretary of the company to be a true copy, of every balance sheet laid before the company in general meeting during the period to which the return relates (including every document required by law to be annexed to the balance sheet); and
- (b) a copy, certified as aforesaid, of the report of the auditors on, and of the report of the directors accompanying, each such balance sheet;

and where any such balance sheet or document required by law to be annexed thereto is in a foreign language, there shall be annexed to that balance sheet a translation in English of the balance sheet or document certified in the prescribed manner to be a correct translation.

(2) If any such balance sheet as aforesaid or document required by law to be annexed thereto did not comply with the requirements of the law as in force at the date of the audit with respect to the form of balance sheets or documents aforesaid, as the case may be, there shall be made such additions to and corrections in the copy as would have been required to be made in the balance sheet or document in order to make it comply with the said requirements, and the fact that the copy has been so amended shall be stated thereon.

(3) If a company fails to comply with this section, the company and every officer of the company who is in default shall be liable to a default fine.

For the purposes of this subsection, the expression 'officer' shall include any person in accordance with whose directions or instructions the directors of the company are accustomed to act.

(4) This section shall not apply to an assurance company which has complied with the provisions of subsection (4) of Section 7 of the Assurance Companies Act, 1909.

129.—(1) A private company shall be excepted from the requirements imposed by Section 127 of this Act if, but only if—

- (a) the conditions mentioned in the next following subsection are satisfied at the date of the return and have been satisfied at all times since the commencement of this Act; and
- (b) there is sent with the return a certificate, signed by the persons signing the certificates required to be so sent by the last foregoing section, that to the best of their knowledge and belief the said conditions are and have been satisfied as aforesaid:

Provided that if at any time it is shown that the said conditions are then satisfied in the case of any private company, the Board of Trade may on the application of the company's directors direct that, in relation to any subsequent annual returns of the company, it shall not be necessary for the said conditions to have been satisfied before that time, and the certificates sent with those returns shall in that event relate only to the period since that time.

(2) The said conditions are—

- (a) that the conditions contained in the Seventh Schedule to this Act are satisfied as to the persons interested in the company's shares and debentures; and
- (b) that the number of persons holding debentures of the company is not more than fifty (joint holders being treated as a single person); and
- (c) that no body corporate is a director of the company and neither the company nor any of the directors is party or privy to any arrangement whereby the policy of the company is capable of being determined by persons other than the directors, members and debenture holders or trustees for debenture holders.

(3) A prosecution shall not be instituted in England in respect of any failure of a private company to comply with Section 127 of this Act except by or with the consent of the Board of Trade.

(4) Any reference in this Act to an exempt private company shall be construed as referring to a company with respect to which the conditions mentioned in subsection (2) of this section are satisfied and have been satisfied at all times since the commencement of this Act or since the giving by the Board of Trade of a direction under the proviso to subsection (1) of this section.

(5) References in this section to the said conditions having been satisfied since the commencement of this Act shall, in relation to a company first registered

after the commencement of this Act, be construed as referring to the conditions having been satisfied since the company's registration.

130. — (1) Every company limited by shares and every company limited by guarantee and having a share capital shall, within a period of not less than one month nor more than three months from the date at which the company is entitled to commence business, hold a general meeting of the members of the company, which shall be called 'the statutory meeting'.

(2) The directors shall, at least fourteen days before the day on which the meeting is held, forward a report (in this Act referred to as 'the statutory report') to every member of the company:

Provided that if the statutory report is forwarded later than is required by this subsection, it shall, notwithstanding that fact, be deemed to have been duly forwarded if it is so agreed by all the members entitled to attend and vote at the meeting.

(3) The statutory report shall be certified by not less than two directors of the company and shall state—

- (a) the total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash, and stating in the case of shares partly paid up the extent to which they are so paid up, and in either case the consideration for which they have been allotted;
- (b) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;
- (c) an abstract of the receipts of the company and of the payments made thereout, up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company;
- (d) the names, addresses and descriptions of the directors, auditors, if any, managers, if any, and secretary of the company; and
- (e) the particulars of any contract the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

(4) The statutory report shall, so far as it relates to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, be certified as correct by the auditors, if any, of the company.

(5) The directors shall cause a copy of the statutory report, certified as required by this section, to be delivered to the registrar of companies for registration forthwith after the sending thereof to the members of the company.

(6) The directors shall cause a list showing the names, descriptions and addresses of the members of the company, and the number of shares held by them respectively, to be produced at the commencement of the meeting and to remain open and accessible to any member of the company during the continuance of the meeting.

(7) The members of the company present at the meeting shall be at liberty to discuss any matter relating to the formation of the company, or arising out of the statutory report, whether previous notice has been given or not, but no resolution of which notice has not been given in accordance with the articles may be passed.

(8) The meeting may adjourn from time to time, and at any adjourned meeting any resolution of which notice has been given in accordance with the articles, either before or subsequently to the former meeting, may be passed, and the adjourned meeting shall have the same powers as an original meeting.

(9) In the event of any default in complying with the provisions of this section, every director of the company who is knowingly and wilfully guilty of the default or, in the case of default by the company, every officer of the company who is in default shall be liable to a fine not exceeding fifty pounds.

(10) This section shall not apply to a private company.

145.—(1) Every company shall cause minutes of all proceedings of general meetings, all proceedings at meetings of its directors and, where there are managers, all proceedings at meetings of its managers to be entered in books kept for that purpose.

(2) Any such minute if purporting to be signed by the chairman of the meeting at which the proceedings were had, or by the chairman of the next succeeding meeting, shall be evidence of the proceedings.

(3) Where minutes have been made in accordance with the provisions of this section of the proceedings at any general meeting of the company or meeting of directors or managers, then, until the contrary is proved, the meeting shall be deemed to have been duly held and convened, and all proceedings had thereat to have been duly had, and all appointments of directors, managers or liquidators shall be deemed to be valid.

(4) If a company fails to comply with subsection (1) of this section, the company and every officer of the company who is in default shall be liable to a default fine.

146.—(1) The books containing the minutes of proceedings of any general meeting of a company held on or after the first day of November, 1929, shall be kept at the registered office of the company, and shall during business hours (subject to such reasonable restrictions as the company may by its articles or in general meeting impose, so that not less than two hours in each day be allowed for inspection) be open to the inspection of any member without charge.

(2) Any member shall be entitled to be furnished within seven days after he has made a request in that behalf to the company with a copy of any such minutes as aforesaid at a charge not exceeding sixpence for every hundred words.

(3) If any inspection required under this section is refused or if any copy required under this section is not sent within the proper time, the company and every officer of the company who is in default shall be liable in respect of each offence to a fine not exceeding two pounds and further to a default fine of two pounds.

(4) In the case of any such refusal or default, the Court may by order compel an immediate inspection of the books in respect of all proceedings of general meetings or direct that the copies required shall be sent to the persons requiring them.

147.—(1) Every company shall cause to be kept proper books of account with respect to—

- (a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place;
- (b) all sales and purchases of goods by the company;
- (c) the assets and liabilities of the company.

(2) For the purposes of the foregoing subsection, proper books of account shall not be deemed to be kept with respect to the matters aforesaid if there are not kept such books as are necessary to give a true and fair view of the state of the company's affairs and to explain its transactions.

(3) The books of account shall be kept at the registered office of the company or at such other place as the directors think fit, and shall at all times be open to inspection by the directors:

Provided that if books of account are kept at a place outside Great Britain there shall be sent to, and kept at a place in, Great Britain and be at all times open to inspection by the directors such accounts and returns with respect to the business dealt with in the books of account so kept as will disclose with reasonable accuracy the financial position of that business at intervals not exceeding six months and will enable to be prepared in accordance with this Act the company's balance sheet, its profit and loss account or income and expenditure account, and any document annexed to any of those documents giving information which is required by this Act and is thereby allowed to be so given.

(4) If any person being a director of a company fails to take all reasonable steps to secure compliance by the company with the requirements of this section, or has by his own wilful act been the cause of any default by the company thereunder, he shall, in respect of each offence, be liable on summary conviction to

imprisonment for a term not exceeding six months or to a fine not exceeding two hundred pounds:

Provided that—

- (a) in any proceedings against a person in respect of an offence under this section consisting of a failure to take reasonable steps to secure compliance by the company with the requirements of this section, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that those requirements were complied with and was in a position to discharge that duty; and
- (b) a person shall not be sentenced to imprisonment for such an offence unless, in the opinion of the Court dealing with the case, the offence was committed wilfully.

148.—(1) The directors of every company shall at some date not later than eighteen months after the incorporation of the company and subsequently once at least in every calendar year lay before the company in general meeting a profit and loss account or, in the case of a company not trading for profit, an income and expenditure account for the period, in the case of the first account, since the incorporation of the company, and, in any other case, since the preceding account, made up to a date not earlier than the date of the meeting by more than nine months, or, in the case of a company carrying on business or having interests abroad, by more than twelve months:

Provided that the Board of Trade, if for any special reason they think fit so to do, may, in the case of any company, extend the period of eighteen months aforesaid, and in the case of any company and with respect to any year extend the periods of nine and twelve months aforesaid.

(2) The directors shall cause to be made out in every calendar year, and to be laid before the company in general meeting, a balance sheet as at the date to which the profit and loss account or the income and expenditure account, as the case may be, is made up.

(3) If any person being a director of a company fails to take all reasonable steps to comply with the provisions of this section, he shall, in respect of each offence, be liable on summary conviction to imprisonment for a term not exceeding six months or to a fine not exceeding two hundred pounds:

Provided that—

- (a) in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the provisions of this section were complied with and was in a position to discharge that duty; and
- (b) a person shall not be sentenced to imprisonment for such an offence unless in the opinion of the Court dealing with the case, the offence was committed wilfully.

149.—(1) Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of its financial year, and every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year.

(2) A company's balance sheet and profit and loss account shall comply with the requirements of the Eighth Schedule to this Act, so far as applicable thereto.

(3) Save as expressly provided in the following provisions of this section or in Part III of the said Eighth Schedule the requirements of the last foregoing subsection and the said Eighth Schedule shall be without prejudice either to the general requirements of subsection (1) of this section or to any other requirements of this Act.

(4) The Board of Trade may, on the application or with the consent of a company's directors, modify in relation to that company any of the requirements of this Act as to the matters to be stated in a company's balance sheet or profit and loss account (except the requirements of subsection (1) of this section) for the purpose of adapting them to the circumstances of the company.

(5) Subsections (1) and (2) of this section shall not apply to a company's profit and loss account if—

- (a) the company has subsidiaries; and
- (b) the profit and loss account is framed as a consolidated profit and loss account dealing with all or any of the company's subsidiaries as well as the company and—
 - (i) complies with the requirements of this Act relating to consolidated profit and loss accounts; and
 - (ii) shows how much of the consolidated profit or loss for the financial year is dealt with in the accounts of the company.

(6) If any person being a director of a company fails to take all reasonable steps to secure compliance as respects any accounts laid before the company in general meeting with the provisions of this section and with the other requirements of this Act as to the matters to be stated in accounts, he shall, in respect of each offence, be liable on summary conviction to imprisonment for a term not exceeding six months or to a fine not exceeding two hundred pounds:

Provided that—

- (a) in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the said provisions or the said other requirements, as the case may be, were complied with and was in a position to discharge that duty; and
 - (b) a person shall not be sentenced to imprisonment for any such offence unless, in the opinion of the Court dealing with the case, the offence was committed wilfully.
- (7) For the purposes of this section and the following provisions of this Act, except where the context otherwise requires—
- (a) any reference to a balance sheet or profit and loss account shall include any notes thereon or document annexed thereto giving information which is required by this Act and is thereby allowed to be so given; and
 - (b) any reference to a profit and loss account shall be taken, in the case of a company not trading for profit, as referring to its income and expenditure account, and references to profit or to loss and, if the company has subsidiaries, references to a consolidated profit and loss account shall be construed accordingly.

150.—(1) Where at the end of its financial year a company has subsidiaries, accounts or statements (in this Act referred to as 'group accounts') dealing as hereinafter mentioned with the state of affairs and profit or loss of the company and the subsidiaries shall, subject to the next following subsection, be laid before the company in general meeting when the company's own balance sheet and profit and loss account are so laid.

(2) Notwithstanding anything in the foregoing subsection—

- (a) group accounts shall not be required where the company is at the end of its financial year the wholly owned subsidiary of another body corporate incorporated in Great Britain; and
- (b) group accounts need not deal with a subsidiary of the company if the company's directors are of opinion that—
 - (i) it is impracticable, or would be of no real value to members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to members of the company; or
 - (ii) the result would be misleading, or harmful to the business of the company or any of its subsidiaries; or
 - (iii) the business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking;

and, if the directors are of such an opinion about each of the company's subsidiaries, group accounts shall not be required:

Provided that the approval of the Board of Trade shall be required for not dealing in group accounts with a subsidiary on the ground that the result would

be harmful or on the ground of the difference between the business of the holding company and that of the subsidiary.

(3) If any person being a director of a company fails to take all reasonable steps to secure compliance as respects the company with the provisions of this section, he shall, in respect of each offence, be liable on summary conviction to imprisonment for a term not exceeding six months or to a fine not exceeding two hundred pounds:

Provided that—

- (a) in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the requirements of this section were complied with and was in a position to discharge that duty; and
 - (b) a person shall not be sentenced to imprisonment for an offence under this section unless, in the opinion of the Court dealing with the case, the offence was committed wilfully.
- (4) For the purposes of this section a body corporate shall be deemed to be the wholly owned subsidiary of another if it has no members except that other and that other's wholly owned subsidiaries and its or their nominees.

151.—(1) Subject to the next following subsection, the group accounts laid before a holding company shall be consolidated accounts comprising—

- (a) a consolidated balance sheet dealing with the state of affairs of the company and all the subsidiaries to be dealt with in group accounts;
 - (b) a consolidated profit and loss account dealing with the profit or loss of the company and those subsidiaries.
- (2) If the company's directors are of opinion that it is better for the purpose—
- (a) of presenting the same or equivalent information about the state of affairs and profit or loss of the company and those subsidiaries; and
 - (b) of so presenting it that it may be readily appreciated by the company's members;

the group accounts may be prepared in a form other than that required by the foregoing subsection, and in particular may consist of more than one set of consolidated accounts dealing respectively with the company and one group of subsidiaries and with other groups of subsidiaries or of separate accounts dealing with each of the subsidiaries, or of statements expanding the information about the subsidiaries in the company's own accounts, or any combination of those forms.

(3) The group accounts may be wholly or partly incorporated in the company's own balance sheet and profit and loss account.

152.—(1) The group accounts laid before a company shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole, so far as concerns members of the company.

(2) Where the financial year of a subsidiary does not coincide with that of the holding company, the group accounts shall, unless the Board of Trade on the application or with the consent of the holding company's directors otherwise direct, deal with the subsidiary's state of affairs as at the end of its financial year ending with or last before that of the holding company, and with the subsidiary's profit or loss for that financial year.

(3) Without prejudice to subsection (1) of this section, the group accounts, if prepared as consolidated accounts, shall comply with the requirements of the Eighth Schedule to this Act, so far as applicable thereto, and if not so prepared shall give the same or equivalent information:

Provided that the Board of Trade may, on the application or with the consent of a company's directors, modify the said requirements in relation to that company for the purpose of adapting them to the circumstances of the company.

153.—(1) A holding company's directors shall secure that except where in their opinion there are good reasons against it, the financial year of each of its subsidiaries shall coincide with the company's own financial year.

(2) Where it appears to the Board of Trade desirable for a holding company or a holding company's subsidiary to extend its financial year so that the

subsidiary's financial year may end with that of the holding company, and for that purpose to postpone the submission of the relevant accounts to a general meeting from one calendar year to the next, the Board may on the application or with the consent of the directors of the company whose financial year is to be extended direct that, in the case of that company, the submission of accounts to a general meeting, the holding of an annual general meeting or the making of an annual return shall not be required in the earlier of the said calendar years.

154.—(1) For the purposes of this Act, a company shall, subject to the provisions of subsection (3) of this section, be deemed to be a subsidiary of another if, but only if—

(a) that other either

- (i) is a member of it and controls the composition of its board of directors; or
- (ii) holds more than half in nominal value of its equity share capital; or
- (b) the first-mentioned company is a subsidiary of any company which is that other's subsidiary.

(2) For the purposes of the foregoing subsection, the composition of a company's board of directors shall be deemed to be controlled by another company if, but only if, that other company by the exercise of some power exercisable by it without the consent or concurrence of any other person can appoint or remove the holders of all or a majority of the directorships; but for the purposes of this provision that other company shall be deemed to have power to appoint to a directorship with respect to which any of the following conditions is satisfied, that is to say—

- (a) that a person cannot be appointed thereto without the exercise in his favour by that other company of such a power as aforesaid; or
- (b) that a person's appointment thereto follows necessarily from his appointment as director of that other company; or
- (c) that the directorship is held by that other company itself or by a subsidiary of it.

(3) In determining whether one company is a subsidiary of another—

- (a) any shares held or power exercisable by that other in a fiduciary capacity shall be treated as not held or exercisable by it;
- (b) subject to the two following paragraphs, any shares held or power exercisable—
 - (i) by any person as a nominee for that other (except where that other is concerned only in a fiduciary capacity); or
 - (ii) by, or by a nominee for, a subsidiary of that other, not being a subsidiary which is concerned only in a fiduciary capacity; shall be treated as held or exercisable by that other;
- (c) any shares held or power exercisable by any person by virtue of the provisions of any debentures of the first-mentioned company or of a trust deed for securing any issue of such debentures shall be disregarded;
- (d) any shares held or power exercisable by, or by a nominee for, that other or its subsidiary (not being held or exercisable as mentioned in the last foregoing paragraph) shall be treated as not held or exercisable by that other if the ordinary business of that other or its subsidiary, as the case may be, includes the lending of money and the shares are held or power is exercisable as aforesaid by way of security only for the purposes of a transaction entered into in the ordinary course of that business.

(4) For the purposes of this Act, a company shall be deemed to be another's holding company if, but only if, that other is its subsidiary.

(5) In this section the expression 'company' includes any body corporate, and the expression 'equity share capital' means, in relation to a company, its issued share capital excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution.

155.—(1) Every balance sheet of a company shall be signed on behalf of the board by two of the directors of the company, or, if there is only one director, by that director.

(2) In the case of a banking company registered after the fifteenth day of August, eighteen hundred and seventy-nine, the balance sheet must be signed by the secretary or manager, if any, and where there are more than three directors of the company by at least three of those directors, and where there are not more than three directors by all the directors.

(3) If any copy of a balance sheet which has not been signed as required by this section is issued, circulated or published, the company and every officer of the company who is in default shall be liable to a fine not exceeding fifty pounds.

156.—(1) The profit and loss account and, so far as not incorporated in the balance sheet or profit and loss account, any group accounts laid before the company in general meeting, shall be annexed to the balance sheet, and the auditors' report shall be attached thereto.

(2) Any accounts so annexed shall be approved by the board of directors before the balance sheet is signed on their behalf.

(3) If any copy of a balance sheet is issued, circulated or published without having annexed thereto a copy of the profit and loss account or any group accounts required by this section to be so annexed, or without having attached thereto a copy of the auditors' report, the company and every officer of the company who is in default shall be liable to a fine not exceeding fifty pounds.

157.—(1) There shall be attached to every balance sheet laid before a company in general meeting a report by the directors with respect to the state of the company's affairs, the amount, if any, which they recommend should be paid by way of dividend, and the amount, if any, which they propose to carry to reserves within the meaning of the Eighth Schedule to this Act.

(2) The said report shall deal, so far as is material for the appreciation of the state of the company's affairs by its members and will not in the directors' opinion be harmful to the business of the company or of any of its subsidiaries, with any change during the financial year in the nature of the company's business, or in the company's subsidiaries, or in the classes of business in which the company has an interest, whether as member of another company or otherwise.

(3) If any person being a director of a company fails to take all reasonable steps to comply with the provisions of subsection (1) of this section, he shall, in respect of each offence, be liable on summary conviction to imprisonment for a term not exceeding six months or to a fine not exceeding two hundred pounds:

Provided that—

(a) in any proceedings against a person in respect of an offence under the said subsection (1), it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the provisions of that subsection were complied with and was in a position to discharge that duty; and

(b) a person shall not be liable to be sentenced to imprisonment for such an offence unless, in the opinion of the court dealing with the case, the offence was committed wilfully.

158.—(1) A copy of every balance sheet, including every document required by law to be annexed thereto, which is to be laid before a company in general meeting, together with a copy of the auditors' report, shall, not less than twenty-one days before the date of the meeting, be sent to every member of the company (whether he is or is not entitled to receive notices of general meetings of the company), every holder of debentures of the company (whether he is or is not so entitled) and all persons other than members or holders of debentures of the company, being persons so entitled:

Provided that—

(a) in the case of a company not having a share capital this subsection shall not require the sending of a copy of the documents aforesaid to a member of the company who is not entitled to receive notices of general meetings of the company or to a holder of debentures of the company who is not so entitled;

(b) this subsection shall not require a copy of those documents to be sent

- (i) to a member of the company or a holder of debentures of the company, being in either case a person who is not entitled to receive notices of general meetings of the company and of whose address the company is unaware;
 - (ii) to more than one of the joint holders of any shares or debentures none of whom are entitled to receive such notices; or
 - (iii) in the case of joint holders of any shares or debentures some of whom are and some of whom are not entitled to receive such notices, to those who are not so entitled; and
- (c) if the copies of the documents aforesaid are sent less than twenty-one days before the date of the meeting, they shall, notwithstanding that fact, be deemed to have been duly sent if it is so agreed by all the members entitled to attend and vote at the meeting.

(2) Any member of a company, whether he is or is not entitled to have sent to him copies of the company's balance sheets, and any holder of debentures of the company, whether he is or is not so entitled, shall be entitled to be furnished on demand without charge with a copy of the last balance sheet of the company, including every document required by law to be annexed thereto, together with a copy of the auditors' report on the balance sheet.

(3) If default is made in complying with subsection (1) of this section, the company and every officer of the company who is in default shall be liable to a fine not exceeding twenty pounds, and if, when any person makes a demand for any document with which he is by virtue of subsection (2) of this section entitled to be furnished, default is made in complying with the demand within seven days after the making thereof, the company and every officer of the company who is in default shall be liable to a default fine, unless it is proved that that person has already made a demand for and been furnished with a copy of the document.

(4) The foregoing provisions of this section shall not have effect in relation to a balance sheet of a private company laid before it before the commencement of this Act, and the right of any person to be furnished with a copy of any such balance sheet and the liability of the company in respect of a failure to satisfy that right shall be the same as they would have been if this Act had not passed.

159.—(1) Every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that, until the conclusion of the next, annual general meeting.

(2) At any annual general meeting a retiring auditor, however appointed, shall be reappointed without any resolution being passed unless—

- (a) he is not qualified for reappointment; or
- (b) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be reappointed; or
- (c) he has given the company notice in writing of his unwillingness to be reappointed:

Provided that where notice is given of an intended resolution to appoint some person or persons in place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with, the retiring auditor shall not be automatically reappointed by virtue of this subsection.

(3) Where at an annual general meeting no auditors are appointed or reappointed, the Board of Trade may appoint a person to fill the vacancy.

(4) The company shall, within one week of the Board's power under the last foregoing subsection becoming exercisable, give them notice of that fact, and, if a company fails to give notice as required by this subsection, the company and every officer of the company who is in default shall be liable to a default fine.

(5) Subject as hereinafter provided, the first auditors of a company may be appointed by the directors at any time before the first annual general meeting, and auditors so appointed shall hold office until the conclusion of that meeting:

Provided that—

- (a) the company may at a general meeting remove any such auditors and appoint in their place any other persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting; and
 - (b) if the directors fail to exercise their powers under this subsection, the company in general meeting may appoint the first auditors, and thereupon the said powers of the directors shall cease.
- (6) The directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act.
- (7) The remuneration of the auditors of a company—
- (a) in the case of an auditor appointed by the directors or by the Board of Trade, may be fixed by the directors or by the Board, as the case may be;
 - (b) subject to the foregoing paragraph, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

For the purposes of this subsection, any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression 'remuneration'.

160.—(1) Special notice shall be required for a resolution at a company's annual general meeting appointing as auditor a person other than a retiring auditor or providing expressly that a retiring auditor shall not be reappointed.

(2) On receipt of notice of such an intended resolution as aforesaid, the company shall forthwith send a copy thereof to the retiring auditor (if any).

(3) Where notice is given of such an intended resolution as aforesaid and the retiring auditor makes with respect to the intended resolution representations in writing to the company (not exceeding a reasonable length) and requests their notification to members of the company, the company shall, unless the representations are received by it too late for it to do so—

- (a) in any notice of the resolution given to members of the company, state the fact of the representations having been made; and
- (b) send a copy of the representations to every member of the company to whom notice of the meeting is sent (whether before or after receipt of the representations by the company);

and if a copy of the representations is not sent as aforesaid because received too late or because of the company's default the auditor may (without prejudice to his right to be heard orally) require that the representations shall be read out at the meeting:

Provided that copies of the representations need not be sent out and the representations need not be read out at the meeting if, on the application either of the company or of any other person who claims to be aggrieved, the Court is satisfied that the rights conferred by this section are being abused to secure needless publicity for defamatory matter; and the Court may order the company's costs on an application under this section to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application.

(4) The last foregoing subsection shall apply to a resolution to remove the first auditors by virtue of subsection (5) of the last foregoing section as it applies in relation to a resolution that a retiring auditor shall not be reappointed.

161.—(1) A person shall not be qualified for appointment as auditor of a company unless either—

- (a) he is a member of a body of accountants established in the United Kingdom and for the time being recognised for the purposes of this provision by the Board of Trade; or
- (b) he is for the time being authorised by the Board of Trade to be so appointed either as having similar qualifications obtained outside the United Kingdom or as having obtained adequate knowledge and experience in the course of his employment by a member of a body of accountants recognised for the purposes of the foregoing paragraph or as having before the sixth day

of August, nineteen hundred and forty-seven, practised in Great Britain as an accountant:

Provided that this subsection shall not apply in the case of a private company which at the time of the auditor's appointment is an exempt private company.

(2) None of the following persons shall be qualified for appointment as auditor of a company:

- (a) an officer or servant of the company;
- (b) a person who is a partner of or in the employment of an officer or servant of the company;
- (c) a body corporate:

Provided that paragraph (b) of this subsection shall not apply in the case of a private company which at the time of the auditor's appointment is an exempt private company.

References in this subsection to an officer or servant shall be construed as not including references to an auditor.

(3) A person shall also not be qualified for appointment as auditor of a company if he is, by virtue of the last foregoing subsection, disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

(4) Notwithstanding anything in the foregoing provisions of this section, a Scottish firm shall be qualified for appointment as auditor of a company if, but only if, all the partners are qualified for appointment as auditor thereof.

(5) Any body corporate which acts as auditor of a company shall be liable to a fine not exceeding one hundred pounds.

162.—(1) The auditors shall make a report to the members on the accounts examined by them, and on every balance sheet, every profit and loss account and all group accounts laid before the company in general meeting during their tenure of office, and the report shall contain statements as to the matters mentioned in the Ninth Schedule to this Act.

(2) The auditors' report shall be read before the company in general meeting and shall be open to inspection by any member.

(3) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of the duties of the auditors.

(4) The auditors of a company shall be entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive and to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditors.

163. References in this Act to a document annexed or required to be annexed to a company's accounts or any of them shall not include the directors' report or the auditors' report:

Provided that any information which is required by this Act to be given in accounts, and is thereby allowed to be given in a statement annexed, may be given in the directors' report instead of in the accounts and, if any such information is so given, the report shall be annexed to the accounts and this Act shall apply in relation thereto accordingly, except that the auditors shall report thereon only so far as it gives the said information.

164.—(1) The Board of Trade may appoint one or more competent inspectors to investigate the affairs of a company and to report thereon in such manner as the Board direct—

- (a) in the case of a company having a share capital, on the application either of not less than two hundred members or of members holding not less than one-tenth of the shares issued;
- (b) in the case of a company not having a share capital, on the application of not less than one-fifth in number of the persons on the company's register of members.

(2) The application shall be supported by such evidence as the Board of Trade may require for the purpose of showing that the applicants have good reason for requiring the investigation, and the Board may, before appointing an inspector, require the applicants to give security, to an amount not exceeding one hundred pounds, for payment of the costs of the investigation.

165. Without prejudice to their powers under the last foregoing section, the Board of Trade—

- (a) shall appoint one or more competent inspectors to investigate the affairs of a company and to report thereon in such manner as the Board direct, if—
 - (i) the company by special resolution; or
 - (ii) the Court by order;
 declares that its affairs ought to be investigated by an inspector appointed by the Board; and
- (b) may do so if it appears to the Board that there are circumstances suggesting
 - (i) that its business is being conducted with intent to defraud its creditors or the creditors of any other person or otherwise for a fraudulent or unlawful purpose or in a manner oppressive of any part of its members or that it was formed for any fraudulent or unlawful purpose; or
 - (ii) that persons concerned with its formation or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards it or towards its members; or
 - (iii) that its members have not been given all the information with respect to its affairs which they might reasonably expect.

166. If an inspector appointed under either of the two last foregoing sections to investigate the affairs of a company thinks it necessary for the purposes of his investigation to investigate also the affairs of any other body corporate which is or has at any relevant time been the company's subsidiary or holding company or a subsidiary of its holding company or a holding company of its subsidiary, he shall have power so to do, and shall report on the affairs of the other body corporate so far as he thinks the results of his investigation thereof are relevant to the investigation of the affairs of the first-mentioned company.

167.—(1) It shall be the duty of all officers and agents of the company and of all officers and agents of any other body corporate whose affairs are investigated by virtue of the last foregoing section to produce to the inspectors all books and documents of or relating to the company or, as the case may be, the other body corporate which are in their custody or power and otherwise to give to the inspectors all assistance in connection with the investigation which they are reasonably able to give.

(2) An inspector may examine on oath the officers and agents of the company or other body corporate in relation to its business, and may administer an oath accordingly.

(3) If any officer or agent of the company or other body corporate refuses to produce to the inspectors any book or document which it is his duty under this section so to produce, or refuses to answer any question which is put to him by the inspectors with respect to the affairs of the company or other body corporate, as the case may be, the inspectors may certify the refusal under their hand to the Court, and the Court may thereupon inquire into the case, and after hearing any witnesses who may be produced against or on behalf of the alleged offender and after hearing any statement which may be offered in defence, punish the offender in like manner as if he had been guilty of contempt of the Court.

(4) If an inspector thinks it necessary for the purpose of his investigation that a person whom he has no power to examine on oath should be so examined, he may apply to the Court and the Court may if it sees fit order that person to attend and be examined on oath before it on any matter relevant to the investigation, and on any such examination—

- (a) the inspector may take part therein either personally or by solicitor or counsel;

- (b) the Court may put such questions to the person examined as the Court thinks fit;
- (c) the person examined shall answer all such questions as the Court may put or allow to be put to him, but may at his own cost employ a solicitor with or without counsel, who shall be at liberty to put to him such questions as the Court may deem just for the purpose of enabling him to explain or qualify any answers given by him;

and notes of the examination shall be taken down in writing, and shall be read over to or by, and signed by, the person examined, and may thereafter be used in evidence against him:

Provided that, notwithstanding anything in paragraph (c) of this subsection, the Court may allow the person examined such costs as in its discretion it may think fit, and any costs so allowed shall be paid as part of the expenses of the investigation.

(5) In this section, any reference to officers or to agents shall include past, as well as present, officers or agents, as the case may be, and for the purposes of this section the expression 'agents', in relation to a company or other body corporate shall include the bankers and solicitors of the company or other body corporate and any persons employed by the company or other body corporate as auditors, whether those persons are or are not officers of the company or other body corporate.

168.—(1) The inspectors may, and, if so directed by the Board of Trade, shall, make interim reports to the Board, and on the conclusion of the investigation shall make a final report to the Board.

Any such report shall be written or printed, as the Board direct.

(2) The Board of Trade shall—

- (a) forward a copy of any report made by the inspectors to the registered office of the company;
 - (b) if the Board think fit, furnish a copy thereof on request and on payment of the prescribed fee to any other person who is a member of the company or of any other body corporate dealt with in the report by virtue of Section 166 of this Act or whose interests as a creditor of the company or of any such other body corporate as aforesaid appear to the Board to be affected,
 - (c) where the inspectors are appointed under Section 164 of this Act, furnish, at the request of the applicants for the investigation, a copy to them; and
 - (d) where the inspectors are appointed under Section 165 of this Act in pursuance of an order of the Court, furnish a copy to the Court;
- and may also cause the report to be printed and published.

169.—(1) If from any report made under the last foregoing section it appears to the Board of Trade that any person has, in relation to the company or to any other body corporate whose affairs have been investigated by virtue of Section 166 of this Act, been guilty of any offence for which he is criminally liable, the Board shall proceed as follows:

- (a) in the case of an offence in England, if it appears to the Board that the case is one in which the prosecution ought to be undertaken by the Director of Public Prosecutions, the Board shall refer the matter to him;
- (b) in the case of an offence in Scotland, the Board shall refer the matter to the Lord Advocate.

(2) If, where any matter is referred to the Director of Public Prosecutions under this section, he considers that the case is one in which a prosecution ought to be instituted, he shall institute proceedings accordingly, and it shall be the duty of all officers and agents of the company or other body corporate as aforesaid, as the case may be (other than the defendant in the proceedings) to give him all assistance in connection with the prosecution which they are reasonably able to give.

Subsection (5) of Section 167 of this Act shall apply for the purposes of this subsection as it applies for the purposes of that section.

(3) If, in the case of any body corporate liable to be wound up under this Act, it appears to the Board of Trade, from any such report as aforesaid that it is expedient so to do by reason of any such circumstances as are referred to in sub-paragraph (i) or (ii) of paragraph (b) of Section 165 of this Act, the Board may, unless the body corporate is already being wound up by the Court, present a petition for it to be so wound up if the Court thinks it just and equitable that it should be wound up or a petition for an order under Section 210 of this Act or both.

(4) If from any such report as aforesaid it appears to the Board of Trade that proceedings ought in the public interest to be brought by any body corporate dealt with by the report for the recovery of damages in respect of any fraud, misfeasance or other misconduct in connection with the promotion or formation of that body corporate or the management of its affairs, or for the recovery of any property of the body corporate which has been misapplied or wrongfully retained, they may themselves bring proceedings for that purpose in the name of the body corporate.

(5) The Board of Trade shall indemnify the body corporate against any costs or expenses incurred by it in or in connection with any proceedings brought by virtue of the last foregoing subsection.

185.—(1) Subject to the provisions of this section, no person shall be capable of being appointed a director of a company which is subject to this section if at the time of his appointment he has attained the age of 70.

(2) Subject as aforesaid, a director of a company which is subject to this section shall vacate his office at the conclusion of the annual general meeting commencing next after he attains the age of 70:

Provided that acts done by a person as director shall be valid notwithstanding that it is afterwards discovered that his appointment had terminated by virtue of this subsection.

(3) Where a person retires by virtue of the last foregoing subsection, no provision for the automatic reappointment of retiring directors in default of another appointment shall apply; and if at the meeting at which he retires the vacancy is not filled it may be filled as a casual vacancy.

(4) Subsection (2) of this section shall not apply to a director who is in office at the commencement of this Act so as to terminate his then appointment before the conclusion of the third annual general meeting commencing after the commencement of this Act, but shall apply so as to terminate it at the conclusion of that meeting if he has attained the age of 70 before the commencement of the meeting.

(5) Nothing in the foregoing provisions of this section shall prevent the appointment of a director at any age, or require a director to retire at any time, if his appointment is or was made or approved by the company in general meeting, but special notice shall be required of any resolution appointing or approving the appointment of a director for it to have effect for the purposes of this subsection and the notice thereof given to the company and by the company to its members must state or must have stated the age of the person to whom it relates.

(6) A person reappointed director on retiring by virtue of subsection (2) of this section, or appointed in place of a director so retiring, shall be treated, for the purpose of determining the time at which he or any other director is to retire, as if he had become director on the day on which the retiring director was last appointed before his retirement, but, except as provided by this subsection, the retirement of a director out of turn by virtue of the said subsection (2) shall be disregarded in determining when any other directors are to retire.

(7) In the case of a company first registered after the beginning of the year 1947, this section shall have effect subject to the provisions of the company's articles; and in the case of a company first registered before the beginning of that year—

(a) this section shall have effect subject to any alterations of the company's articles made after the beginning thereof; and

- (b) if at the beginning thereof the company's articles contained provision for retirement of directors under an age limit or for preventing or restricting appointments of directors over a given age this section shall not apply to directors to whom that provision applies.

(8) A company shall be subject to this section if it is not a private company or if, being a private company, it is the subsidiary of a body corporate incorporated in the United Kingdom which is neither a private company nor a company registered under the law relating to companies for the time being in force in Northern Ireland and having provisions in its constitution which would, if it had been registered in Great Britain, entitle it to rank as a private company; and for the purposes of any other section of this Act which refers to a company subject to this section, a company shall be deemed to be subject to this section notwithstanding that all or any of the provisions thereof are excluded or modified by the company's articles.

189.—(1) It shall not be lawful for a company to pay a director remuneration (whether as director or otherwise) free of income-tax or of income-tax other than sur-tax, or otherwise calculated by reference to or varying with the amount of his income-tax or his income-tax other than sur-tax, or to or with the rate or standard rate of income-tax, except under a contract which was in force on the eighteenth day of July, nineteen hundred and forty-five, and provides expressly, and not by reference to the articles, for payment of remuneration as aforesaid.

(2) Any provision contained in a company's articles, or in any contract other than such a contract as aforesaid, or in any resolution of a company or a company's directors, for payment to a director of remuneration as aforesaid shall have effect as if it provided for payment, as a gross sum subject to income-tax and sur-tax, of the net sum for which it actually provides.

(3) This section shall not apply to remuneration due before the commencement of this Act or in respect of a period before the commencement of this Act.

190.—(1) It shall not be lawful for a company to make a loan to any person who is its director or a director of its holding company, or to enter into any guarantee or provide any security in connection with a loan made to such a person as aforesaid by any other person:

Provided that nothing in this section shall apply either—

- (a) to anything done by a company which is for the time being an exempt private company; or
 - (b) to anything done by a subsidiary, where the director is its holding company; or
 - (c) subject to the next following subsection, to anything done to provide any such person as aforesaid with funds to meet expenditure incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an officer of the company; or
 - (d) in the case of a company whose ordinary business includes the lending of money or the giving of guarantees in connection with loans made by other persons, to anything done by the company in the ordinary course of that business.
- (2) Proviso (c) to the foregoing subsection shall not authorise the making of any loan, or the entering into any guarantee, or the provision of any security, except either—
- (a) with the prior approval of the company given at a general meeting at which the purposes of the expenditure and the amount of the loan or the extent of the guarantee or security, as the case may be, are disclosed; or
 - (b) on condition that, if the approval of the company is not given as aforesaid at or before the next following annual general meeting, the loan shall be repaid or the liability under the guarantee or security shall be discharged, as the case may be, within six months from the conclusion of that meeting.

(3) Where the approval of the company is not given as required by any such condition, the directors authorising the making of the loan, or the entering into

the guarantee, or the provision of the security, shall be jointly and severally liable to indemnify the company against any loss arising therefrom.

191. It shall not be lawful for a company to make to any director of the company any payment by way of compensation for loss of office, or as consideration for or in connection with his retirement from office, without particulars with respect to the proposed payment (including the amount thereof) being disclosed to members of the company and the proposal being approved by the company.

192.—(1) It is hereby declared that it is not lawful in connection with the transfer of the whole or any part of the undertaking or property of a company for any payment to be made to any director of the company by way of compensation for loss of office, or as consideration for or in connection with his retirement from office, unless particulars with respect to the proposed payment (including the amount thereof) have been disclosed to the members of the company and the proposal approved by the company.

(2) Where a payment which is hereby declared to be illegal is made to a director of the company, the amount received shall be deemed to have been received by him in trust for the company.

193.—(1) Where, in connection with the transfer to any persons of all or any of the shares in a company, being a transfer resulting from—

- (a) an offer made to the general body of shareholders;
- (b) an offer made by or on behalf of some other body corporate with a view to the company becoming its subsidiary or a subsidiary of its holding company;
- (c) an offer made by or on behalf of an individual with a view to his obtaining the right to exercise or control the exercise of not less than one-third of the voting power at any general meeting of the company; or
- (d) any other offer which is conditional on acceptance to a given extent;

a payment is to be made to a director of the company by way of compensation for loss of office or as consideration for or in connection with his retirement from office, it shall be the duty of that director to take all reasonable steps to secure that particulars with respect to the proposed payment (including the amount thereof) shall be included in or sent with any notice of the offer made for their shares which is given to any shareholders.

(2) If—

- (a) any such director fails to take reasonable steps as aforesaid; or
- (b) any person who has been properly required by any such director to include the said particulars in or send them with any such notice as aforesaid fails so to do;

he shall be liable to a fine not exceeding twenty-five pounds.

(3) If—

- (a) the requirements of subsection (1) of this section are not complied with in relation to any such payment as is therein mentioned; or
- (b) the making of the proposed payment is not, before the transfer of any shares in pursuance of the offer, approved by a meeting summoned for the purpose of the holders of the shares to which the offer relates and of other holders of shares of the same class as any of the said shares;

any sum received by the director on account of the payment shall be deemed to have been received by him in trust for any persons who have sold their shares as a result of the offer made, and the expenses incurred by him in distributing that sum amongst those persons shall be borne by him and not retained out of that sum.

(4) Where the shareholders referred to in paragraph (b) of the last foregoing subsection are not all the members of the company and no provision is made by the articles for summoning or regulating such a meeting as is mentioned in that paragraph, the provisions of this Act and of the company's articles relating to general meetings of the company shall, for that purpose, apply to the meeting either without modification or with such modifications as the Board of Trade on the application of any person concerned may direct for the purpose of adapting them to the circumstances of the meeting.

(5) If at a meeting summoned for the purpose of approving any payment as required by paragraph (b) of subsection (3) of this section a quorum is not present and, after the meeting has been adjourned to a later date a quorum is again not present, the payment shall be deemed for the purposes of that subsection to have been approved.

194.—(1) Where in proceedings for the recovery of any payment as having, by virtue of subsections (1) and (2) of the last but one foregoing section or subsections (1) and (3) of the last foregoing section, been received by any person in trust, it is shown that—

(a) the payment was made in pursuance of any arrangement entered into as part of the agreement for the transfer in question, or within one year before or two years after that agreement or the offer leading thereto; and

(b) the company or any person to whom the transfer was made was privy to that arrangement;

the payment shall be deemed, except in so far as the contrary is shown, to be one to which the subsections apply.

(2) If in connection with any such transfer as is mentioned in either of the two last foregoing sections—

(a) the price to be paid to a director of the company whose office is to be abolished or who is to retire from office for any shares in the company held by him is in excess of the price which could at the time have been obtained by other holders of the like shares; or

(b) any valuable consideration is given to any such director;

the excess or the money value of the consideration, as the case may be, shall for the purposes of that section, be deemed to have been a payment made to him by way of compensation for loss of office or as consideration for or in connection with his retirement from office.

(3) It is hereby declared that references in the three last foregoing sections to payments made to any director of a company by way of compensation for loss of office, or as consideration for or in connection with his retirement from office, do not include any bona fide payment by way of damages for breach of contract or by way of pension in respect of past services, and for the purposes of this subsection the expression 'pension' includes any superannuation allowance, superannuation gratuity or similar payment.

(4) Nothing in the two last foregoing sections shall be taken to prejudice the operation of any rule of law requiring disclosure to be made with respect to any such payments as are therein mentioned or with respect to any other like payments made or to be made to the directors of a company.

195.—(1) Every company shall keep a register showing as respects each director of the company (not being its holding company) the number, description and amount of any shares in or debentures of the company or any other body corporate, being the company's subsidiary or holding company, or a subsidiary of the company's holding company, which are held by or in trust for him or of which he has any right to become the holder (whether on payment or not):

Provided that the register need not include shares in any body corporate which is the wholly-owned subsidiary of another body corporate, and for this purpose a body corporate shall be deemed to be the wholly-owned subsidiary of another if it has no members but that other and that other's wholly-owned subsidiaries and its or their nominees.

(2) Where any shares or debentures fall to be or cease to be recorded in the said register in relation to any director by reason of a transaction entered into after the commencement of this Act and while he is a director, the register shall also show the date of, and price or other consideration for, the transaction:

Provided that where there is an interval between the agreement for any such transaction and the completion thereof, the date shall be that of the agreement.

(3) The nature and extent of a director's interest or right in or over any shares

or debentures recorded in relation to him in the said register shall if he so requires, be indicated in the register.

(4) The company shall not, by virtue of anything done for the purposes of this section, be affected with notice of, or put upon inquiry as to, the rights of any person in relation to any shares or debentures.

(5) The said register shall, subject to the provisions of this section, be kept at the company's registered office and shall be open to inspection during business hours (subject to such reasonable restrictions as the company may by its articles or in general meeting impose, so that not less than two hours in each day be allowed for inspection) as follows:

- (a) during the period beginning fourteen days before the date of the company's annual general meeting and ending three days after the date of its conclusion, it shall be open to the inspection of any member or holder of debentures of the company; and
- (b) during that or any other period, it shall be open to the inspection of any person acting on behalf of the Board of Trade.

In computing the fourteen days and the three days mentioned in this subsection, any day which is a Saturday or Sunday or a bank holiday shall be disregarded.

(6) Without prejudice to the rights conferred by the last foregoing subsection, the Board of Trade may at any time require a copy of the said register, or any part thereof.

(7) The said register shall also be produced at the commencement of the company's annual general meeting and remain open and accessible during the continuance of the meeting to any person attending the meeting.

(8) If default is made in complying with the last foregoing subsection the company and every officer of the company who is in default shall be liable to a fine not exceeding fifty pounds; and if default is made in complying with subsection (1) or (2) of this section, or if any inspection required under this section is refused or any copy required thereunder is not sent within a reasonable time, the company and every officer of the company who is in default shall be liable to a fine not exceeding five hundred pounds and further to a default fine of two pounds.

(9) In the case of any such refusal, the Court may by order compel an immediate inspection of the register.

(10) For the purposes of this section—

- (a) any person in accordance with whose directions or instructions the directors of a company are accustomed to act shall be deemed to be a director of the company; and
- (b) a director of a company shall be deemed to hold, or to have any interest or right in or over, any shares or debentures if a body corporate other than the company holds them or has that interest or right in or over them, and either—
 - (i) that body corporate or its directors are accustomed to act in accordance with his directions or instructions; or
 - (ii) he is entitled to exercise or control the exercise of one-third or more of the voting power at any general meeting of that body corporate.

196.—(1) In any accounts of a company laid before it in general meeting, or in a statement annexed thereto, there shall, subject to and in accordance with the provisions of this section, be shown so far as the information is contained in the company's books and papers or the company has the right to obtain it from the persons concerned—

- (a) the aggregate amount of the directors' emoluments;
- (b) the aggregate amount of directors' or past directors' pensions; and
- (c) the aggregate amount of any compensation to directors or past directors in respect of loss of office.

(2) The amount to be shown under paragraph (a) of subsection (1) of this section—

(a) shall include any emoluments paid to or receivable by any person in respect of his services as director of the company or in respect of his services, while director of the company, as director of any subsidiary thereof or otherwise in connection with the management of the affairs of the company or any subsidiary thereof; and

(b) shall distinguish between emoluments in respect of services as director, whether of the company or its subsidiary, and other emoluments;

and for the purposes of this section the expression 'emoluments', in relation to a director, includes fees and percentages, any sums paid by way of expenses allowance in so far as those sums are charged to United Kingdom income-tax, any contribution paid in respect of him under any pension scheme and the estimated money value of any other benefits received by him otherwise than in cash.

(3) The amount to be shown under paragraph (b) of the said subsection (1)—

(a) shall not include any pension paid or receivable under a pension scheme if the scheme is such that the contributions thereunder are substantially adequate for the maintenance of the scheme, but save as aforesaid shall include any pension paid or receivable in respect of any such services of a director or past director of the company as are mentioned in the last foregoing subsection, whether to or by him or, on his nomination or by virtue of dependence on or other connection with him, to or by any other person; and

(b) shall distinguish between pensions in respect of services as director, whether of the company or its subsidiary, and other pensions;

and for the purposes of this section the expression 'pension' includes any superannuation allowance, superannuation gratuity or similar payment, and the expression 'pension scheme' means a scheme for the provision of pensions in respect of services as director or otherwise which is maintained in whole or in part by means of contributions, and the expression 'contribution' in relation to a pension scheme means any payment (including an insurance premium) paid for the purposes of the scheme by or in respect of persons rendering services in respect of which pensions will or may become payable under the scheme, except that it does not include any payment in respect of two or more persons if the amount paid in respect of each of them is not ascertainable.

(4) The amount to be shown under paragraph (c) of the said subsection (1)—

(a) shall include any sums paid to or receivable by a director or past director by way of compensation for the loss of office as director of the company or for the loss, while director of the company or on or in connection with his ceasing to be a director of the company, of any other office in connection with the management of the company's affairs or of any office as director or otherwise in connection with the management of the affairs of any subsidiary thereof; and

(b) shall distinguish between compensation in respect of the office of director, whether of the company or its subsidiary, and compensation in respect of other offices;

and for the purposes of this section references to compensation for loss of office shall include sums paid as consideration for or in connection with a person's retirement from office.

(5) The amounts to be shown under each paragraph of the said subsection (1)—

(a) shall include all relevant sums paid by or receivable from—

(i) the company; and

(ii) the company's subsidiaries; and

(iii) any other person;

except sums to be accounted for to the company or any of its subsidiaries or, by virtue of Section 193 of this Act, to past or present members of the company or any of its subsidiaries or any class of those members; and

(b) shall distinguish, in the case of the amount to be shown under paragraph (c) of the said subsection (1), between the sums respectively paid by or receivable from the company, the company's subsidiaries and persons other than the company and its subsidiaries.

(6) The amounts to be shown under this section for any financial year shall be the sums receivable in respect of that year, whenever paid, or, in the case of sums not receivable in respect of a period, the sums paid during that year, so, however, that where—

- (a) any sums are not shown in the accounts for the relevant financial year on the ground that the person receiving them is liable to account therefor as mentioned in paragraph (a) of the last foregoing subsection, but the liability is thereafter wholly or partly released or is not enforced within a period of two years; or
- (b) any sums paid by way of expenses allowance are charged to United Kingdom income-tax after the end of the relevant financial year;

those sums shall, to the extent to which the liability is released or not enforced or they are charged as aforesaid, as the case may be, be shown in the first accounts in which it is practicable to show them or in a statement annexed thereto, and shall be distinguished from the amounts to be shown therein apart from this provision.

(7) Where it is necessary so to do for the purpose of making any distinction required by this section in any amount to be shown thereunder, the directors may apportion any payments between the matters in respect of which they have been paid or are receivable in such manner as they think appropriate.

(8) If in the case of any accounts the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report thereon, so far as they are reasonably able to do so, a statement giving the required particulars.

(9) In this section any reference to a company's subsidiary—

- (a) in relation to a person who is or was, while a director of the company, a director also, by virtue of the company's nomination, direct or indirect, of any other body corporate, shall, subject to the following paragraph, include that body corporate, whether or not it is or was in fact the company's subsidiary; and
- (b) shall for the purposes of subsections (2) and (3) be taken as referring to a subsidiary at the time the services were rendered, and for the purposes of subsection (4) be taken as referring to a subsidiary immediately before the loss of office as director of the company.

197.—(1) The accounts which, in pursuance of this Act, are to be laid before every company in general meeting shall, subject to the provisions of this section, contain particulars showing—

- (a) the amount of any loans made during the company's financial year to—
 - (i) any officer of the company; or
 - (ii) any person who, after the making of the loan, became during that year an officer of the company;
 by the company or a subsidiary thereof or by any other person under a guarantee from or on a security provided by the company or a subsidiary thereof (including any such loans which were repaid during that year); and
- (b) the amount of any loans made in manner aforesaid to any such officer or person as aforesaid at any time before the company's financial year and outstanding at the expiration thereof.

(2) The foregoing subsection shall not require the inclusion in accounts of particulars of—

- (a) a loan made in the ordinary course of its business by the company or a subsidiary thereof, where the ordinary business of the company or, as the case may be, the subsidiary, includes the lending of money; or
- (b) a loan made by the company or a subsidiary thereof to an employee of the company or subsidiary, as the case may be, if the loan does not exceed two thousand pounds and is certified by the directors of the company or subsidiary, as the case may be, to have been made in accordance with any practice adopted or about to be adopted by the company or subsidiary with respect to loans to its employees;

not being, in either case, a loan made by the company under a guarantee from

or on a security provided by a subsidiary thereof or a loan made by a subsidiary of the company under a guarantee from or on a security provided by the company or any other subsidiary thereof.

(3) If in the case of any such accounts as aforesaid the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report on the balance sheet of the company, so far as they are reasonably able to do so, a statement giving the required particulars.

(4) References in this section to a subsidiary shall be taken as referring to a subsidiary at the end of the company's financial year (whether or not a subsidiary at the date of the loan).

200.—(1) Every company shall keep at its registered office a register of its directors and secretaries.

(2) The said register shall contain the following particulars with respect to each director, that is to say—

(a) in the case of an individual, his present Christian name and surname, any former Christian name or surname, his usual residential address, his nationality, his business occupation, if any, particulars of any other directorships held by him and, in the case of a company subject to Section 185 of this Act, the date of his birth; and

(b) in the case of a corporation, its corporate name and registered or principal office:

Provided that it shall not be necessary for the register to contain particulars of directorships held by a director in companies of which the company is the wholly-owned subsidiary, or which are the wholly-owned subsidiaries either of the company or of another company of which the company is the wholly-owned subsidiary, and for the purposes of this proviso—

(i) the expression 'company' shall include any body corporate incorporated in Great Britain; and

(ii) a body corporate shall be deemed to be the wholly-owned subsidiary of another if it has no members except that other and that other's wholly-owned subsidiaries and its or their nominees.

(3) The said register shall contain the following particulars with respect to the secretary or, where there are joint secretaries, with respect to each of them, that is to say—

(a) in the case of an individual, his present Christian name and surname, any former Christian name and surname and his usual residential address; and

(b) in the case of a corporation or a Scottish firm, its corporate or firm name and registered or principal office:

Provided that, where all the partners in a firm are joint secretaries, the name and principal office of the firm may be stated instead of the said particulars.

(4) The company shall, within the periods respectively mentioned in the next following subsection, send to the registrar of companies a return in the prescribed form containing the particulars specified in the said register and a notification in the prescribed form of any change among its directors or in its secretary or in any of the particulars contained in the register, specifying the date of the change.

(5) The periods referred to in the last foregoing subsection are the following, namely—

(a) the period within which the said return is to be sent shall be a period of fourteen days from the appointment of the first directors of the company; and

(b) the period within which the said notification of a change is to be sent shall be fourteen days from the happening thereof:

Provided that, in the case of a return containing particulars with respect to any person who is the company's secretary at the commencement of this Act, the period shall be fourteen days from the commencement of this Act.

(6) The register to be kept under this section shall during business hours (subject to such reasonable restrictions as the company may by its articles or in general meeting impose, so that not less than two hours in each day be allowed

for inspection) be open to the inspection of any member of the company without charge and of any other person on payment of one shilling, or such less sum as the company may prescribe, for each inspection.

(7) If any inspection required under this section is refused or if default is made in complying with subsection (1), (2), (3) or (4) of this section, the company and every officer of the company who is in default shall be liable to a default fine.

(8) In the case of any such refusal, the Court may by order compel an immediate inspection of the register.

(9) For the purposes of this section—

- (a) a person in accordance with whose directions or instructions the directors of a company are accustomed to act shall be deemed to be a director and officer of the company;
- (b) the expression 'Christian name' includes a forename;
- (c) in the case of a peer or person usually known by a title different from his surname, the expression 'surname' means that title;
- (d) references to a former Christian name or surname do not include—
 - (i) in the case of a peer or a person usually known by a British title different from his surname, the name by which he was known previous to the adoption of or succession to the title; or
 - (ii) in the case of any person, a former Christian name or surname where that name or surname was changed or disused before the person bearing the name attained the age of eighteen years or has been changed or disused for a period of not less than twenty years; or
 - (iii) in the case of a married woman, the name or surname by which she was known previous to the marriage.

205. Subject as hereinafter provided, any provision, whether contained in the articles of a company or in any contract with a company or otherwise, for exempting any officer of the company or any person (whether an officer of the company or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company shall be void:

Provided that—

- (a) nothing in this section shall operate to deprive any person of any exemption or right to be indemnified in respect of anything done or omitted to be done by him while any such provision was in force; and
- (b) notwithstanding anything in this section, a company may, in pursuance of any such provision as aforesaid, indemnify any such officer or auditor against any liability incurred by him in defending any proceedings, whether civil or criminal in which judgment is given in his favour or in which he is acquitted or in connection with any application under Section 448 of this Act in which relief is granted to him by the Court.

331.—(1) If where a company is wound up it is shown that proper books of account were not kept by the company throughout the period of two years immediately preceding the commencement of the winding up, or the period between the incorporation of the company and the commencement of the winding up, whichever is the shorter, every officer of the company who is in default shall, unless he shows that he acted honestly and that in the circumstances in which the business of the company was carried on the default was excusable, be liable on conviction on indictment to imprisonment for a term not exceeding one year, or on summary conviction to imprisonment for a term not exceeding six months.

(2) For the purposes of this section, proper books of account shall be deemed not to have been kept in the case of any company if there have not been kept such books or accounts as are necessary to exhibit and explain the transactions and financial position of the trade or business of the company, including books containing entries from day to day in sufficient detail of all cash received and cash paid, and, where the trade or business has involved dealings in goods, statements of the annual stocktakings and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient detail to enable those goods and those buyers and sellers to be identified.

333.—(1) If in the course of winding up a company it appears that any person who has taken part in the formation or promotion of the company, or any past or present director, manager or liquidator, or any officer of the company, has misapplied or retained or become liable or accountable for any money or property of the company, or been guilty of any misfeasance or breach of trust in relation to the company, the Court may, on the application of the Official Receiver, or of the liquidator, or of any creditor or contributory, examine into the conduct of the promotor, director, manager, liquidator or officer, and compel him to repay or restore the money or property or any part thereof respectively with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust as the Court thinks just.

(2) The provisions of this section shall have effect notwithstanding that the offence is one for which the offender may be criminally liable.

(3) Where in the case of a winding up in England an order for payment of money is made under this section, the order shall be deemed to be a final judgment within the meaning of paragraph (g) of subsection (1) of Section 1 of the Bankruptcy Act, 1914.

334.—(1) If it appears to the Court in the course of a winding up by, or subject to the supervision of, the Court that any past or present officer, or any member, of the company has been guilty of any offence in relation to the company for which he is criminally liable, the Court may, either on the application of any person interested in the winding up or of its own motion, direct the liquidator to refer the matter, in the case of a winding up in England, to the Director of Public Prosecutions, and, in the case of a winding up in Scotland, to the Lord Advocate.

(2) If it appears to the liquidator in the course of a voluntary winding up that any past or present officer, or any member, of the company has been guilty of an offence in relation to the company for which he is criminally liable, he shall forthwith report the matter, in the case of a winding up in England, to the Director of Public Prosecutions, and, in the case of a winding up in Scotland, to the Lord Advocate, and shall furnish to the Director or Lord Advocate, as the case may be, such information and give to him such access to and facilities for inspecting and taking copies of any documents, being information or documents in the possession or under the control of the liquidator and relating to the matter in question, as they respectively may require.

(3) Where any report is made under the last foregoing subsection to the Director of Public Prosecutions or Lord Advocate, he may, if he thinks fit, refer the matter to the Board of Trade for further enquiry, and the Board shall thereupon investigate the matter and may if they think it expedient, apply to the Court for an order conferring on the Board or any person designated by the Board for the purpose with respect to the company concerned all such powers of investigating the affairs of the company as are provided by this Act in the case of a winding up by the Court.

(4) If it appears to the Court in the course of a voluntary winding up that any past or present officer, or any member, of the company has been guilty as aforesaid, and that no report with respect to the matter has been made by the liquidator to the Director of Public Prosecutions or the Lord Advocate under subsection (2) of this section, the Court may, on the application of any person interested in the winding up or of its own motion, direct the liquidator to make such a report, and on a report being made accordingly the provisions of this section shall have effect as though the report had been made in pursuance of the provisions of subsection (2) of this section.

(5) If, where any matter is reported or referred to the Director of Public Prosecutions or Lord Advocate under this section, he considers that the case is one in which a prosecution ought to be instituted, he shall institute proceedings accordingly, and it shall be the duty of the liquidator and of every officer and agent of the company past and present (other than the defendant in the proceedings) to give him all assistance in connection with the prosecution which he is reasonably able to give.

For the purposes of this subsection, the expression 'agent' in relation to a

company shall be deemed to include any banker or solicitor of the company and any person employed by the company as auditor, whether that person is or is not an officer of the company.

(6) If any person fails or neglects to give assistance in manner required by the last foregoing subsection, the Court may, on the application of the Director of Public Prosecutions or Lord Advocate, as the case may be, direct that person to comply with the requirements of the said subsection, and where any such application is made with respect to a liquidator the Court may, unless it appears that the failure or neglect to comply was due to the liquidator not having in his hands sufficient assets of the company to enable him so to do, direct that the costs of the application shall be borne by the liquidator personally.

410.—(1) Every oversea company shall, in every calendar year, make out a balance sheet and profit and loss account and, if the company is a holding company, group accounts, in such form, and containing such particulars and including such documents, as under the provisions of this Act (subject, however, to any prescribed exceptions) it would, if it had been a company within the meaning of this Act, have been required to make out and lay before the company in general meeting, and deliver copies of those documents to the registrar of companies:

Provided that a company registered under the law relating to companies for the time being in force in Northern Ireland and having provisions in its constitution which would, if it had been registered in Great Britain, entitle it to rank as a private company, need not comply with the foregoing provisions of this subsection if there is delivered to the registrar a certificate signed by a director and by the secretary of the company that, had Section 129 of, and the Seventh Schedule to, this Act extended to Northern Ireland it would at the date of the certificate have been an exempt private company.

(2) If any such document as is mentioned in the foregoing subsection is not written in the English language, there shall be annexed to it a certified translation thereof.

433.—(1) Every company, being a limited banking company or an insurance company or a deposit, provident, or benefit society, shall, before it commences business, and also on the first Monday in February and the first Tuesday in August in every year during which it carries on business, make a statement in the form set out in the Thirteenth Schedule to this Act, or as near thereto as circumstances admit.

(2) A copy of the statement shall be put up in a conspicuous place in the registered office of the company, and in every branch office or place where the business of the company is carried on.

(3) Every member and every creditor of the company shall be entitled to a copy of the statement, on payment of a sum not exceeding sixpence.

(4) If default is made in complying with this section, the company and every officer of the company who is in default shall be liable to a default fine.

(5) For the purposes of this Act a company which carries on the business of insurance in common with any other business or businesses shall be deemed to be an insurance company.

(6) This section shall not apply to any assurance company to which the provisions of the Assurance Companies Act, 1909, as to the accounts and balance sheet to be prepared annually and deposited by such a company apply, if the company complies with those provisions.

Application of certain Provisions of this Act to Unregistered Companies

435.—(1) The provisions of this Act specified in the second column of the Fourteenth Schedule to this Act (which respectively relate to the matters referred to in the first column of that Schedule) shall apply to all bodies corporate incorporated in and having a principal place of business in Great Britain, other than those mentioned in the next following subsection, as if they were companies registered under this Act, but subject to any limitations mentioned in relation to those provisions respectively in the third column of that Schedule and to such adaptations and modifications (if any) as may be specified by regulations made by the Board of Trade.

(2) The said provisions shall not apply by virtue of this section to any of the following, that is to say:

(a) any body incorporated by or registered under any public general Act of Parliament; and

(b) any body not formed for the purpose of carrying on a business which has for its object the acquisition of gain by the body or by the individual members thereof; and

(c) any body for the time being exempted by direction of the Board of Trade.

(3) The said provisions shall apply also in like manner in relation to any unincorporated body of persons entitled by virtue of letters patent to any of the privileges conferred by the Chartered Companies Act, 1837, and not registered under any other public general Act of Parliament, but subject to the like exceptions as are provided for in the case of bodies corporate by paragraphs (b) and (c) of the last foregoing subsection.

(4) This section shall not repeal or revoke in whole or in part any enactment, royal charter or other instrument constituting or regulating any body in relation to which the said provisions are applied by virtue of this section, or restrict the power of His Majesty to grant a charter in lieu of or supplementary to any such charter as aforesaid; but, in relation to any such body, the operation of any such enactment, charter or instrument shall be suspended in so far as it is inconsistent with any of the said provisions as they apply for the time being to that body.

(5) The powers to make regulations conferred by this section and the Fourteenth Schedule to this Act on the Board of Trade shall be exercisable by statutory instrument which shall be subject to annulment in pursuance of a resolution of either House of Parliament.

448.—(1) If in any proceedings for negligence, default, breach of duty or breach of trust against an officer of a company or a person employed by a company as auditor (whether he is or is not an officer of the company) it appears to the Court hearing the case that that officer or person is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that Court may relieve him, either wholly or partly, from his liability on such terms as the Court may think fit.

(2) Where any such officer or person aforesaid has reason to apprehend that any claim will or might be made against him in respect of any negligence, default, breach of duty or breach of trust, he may apply to the Court for relief, and the Court on any such application shall have the same power to relieve him as under this section it would have had if it had been a Court before which proceedings against that person for negligence, default, breach of duty or breach of trust had been brought.

(3) Where any case to which subsection (1) of this section applies is being tried by a judge with a jury, the judge, after hearing the evidence, may, if he is satisfied that the defendant ought in pursuance of that subsection to be relieved either in whole or in part from the liability sought to be enforced against him, withdraw the case in whole or in part from the jury and forthwith direct judgment to be entered for the defendant on such terms as to costs or otherwise as the judge may think proper.

454.—(1) The Board of Trade shall have power by regulations made by statutory instrument to alter or add to the requirements of this Act as to the matters to be stated in a company's balance sheet, profit and loss account and group accounts, and in particular of those of the Eighth Schedule to this Act; and any reference in this Act to the said Eighth Schedule shall be construed as a reference to that Schedule with any alterations or additions made by regulations for the time being in force under this subsection.

(2) The Board of Trade may by regulations made by statutory instrument—

(a) alter Table A, the Twelfth Schedule to this Act so that it does not increase the amount of fees payable to the registrar under that Schedule, and the form in the Thirteenth Schedule to this Act; and

- (b) alter or add to Tables B, C, D, and E in the First Schedule to this Act and the forms in the Second Schedule and Part II of the Sixth Schedule to this Act;

but no alteration made by the Board of Trade in Table A shall affect any company registered before the alteration, or repeal as respects that company any portion of that Table.

(3) No regulations shall be made under subsection (1) of this section so as to render more onerous the requirements therein referred to, unless a draft of the instrument containing the regulations has been laid before Parliament and has been approved by resolution of each House of Parliament.

(4) A statutory instrument containing regulations made under this section, not being regulations to which the last foregoing subsection applies, shall be subject to annulment in pursuance of a resolution of either House of Parliament.

FOURTH SCHEDULE

MATTERS TO BE SPECIFIED IN PROSPECTUS AND REPORTS TO BE SET OUT THEREIN

PART I

MATTERS TO BE SPECIFIED

1. The number of founders or management or deferred shares, if any, and the nature and extent of the interest of the holders in the property and profits of the company.

2. The number of shares, if any, fixed by the articles as the qualification of a director, and any provision in the articles as to the remuneration of the directors.

3. The names, descriptions and addresses of the directors or proposed directors.

4. Where shares are offered to the public for subscription, particulars as to—

(a) the minimum amount which, in the opinion of the directors, must be raised by the issue of those shares in order to provide the sums, or, if any part thereof is to be defrayed in any other manner, the balance of the sums, required to be provided in respect of each of the following matters:

(i) the purchase price of any property purchased or to be purchased which is to be defrayed in whole or in part out of the proceeds of the issue;

(ii) any preliminary expenses payable by the company, and any commission so payable to any person in consideration of his agreeing to subscribe for, or of his procuring or agreeing to procure subscriptions for, any shares in the company;

(iii) the repayment of any moneys borrowed by the company in respect of any of the foregoing matters;

(iv) working capital; and

(b) the amounts to be provided in respect of the matters aforesaid otherwise than out of the proceeds of the issue and the sources out of which those amounts are to be provided.

5. The time of the opening of the subscription lists.

6. The amount payable on application and allotment on each share, and, in the case of a second or subsequent offer of shares, the amount offered for subscription on each previous allotment made within the two preceding years, the amount actually allotted, and the amount, if any, paid on the shares so allotted.

7. The number, description and amount of any shares in or debentures of the company which any person has, or is entitled to be given, an option to subscribe for, together with the following particulars of the option, that is to say—

(a) the period during which it is exercisable;

(b) the price to be paid for shares or debentures subscribed for under it;

(c) the consideration (if any) given or to be given for it or for the right to it;

(d) the names and addresses of the persons to whom it or the right to it was given or, if given to existing shareholders or debenture-holders as such, the relevant shares or debentures.

8. The number and amount of shares and debentures which within the two preceding years have been issued, or agreed to be issued, as fully or partly paid up otherwise than in cash, and in the latter case the extent to which they are so paid up, and in either case the consideration for which those shares or debentures have been issued or are proposed or intended to be issued.

9.—(1) As respects any property to which this paragraph applies—

- (a) the names and addresses of the vendors;
- (b) the amount payable in cash, shares or debentures to the vendor and, where there is more than one separate vendor, or the company is a sub-purchaser, the amount so payable to each vendor;
- (c) short particulars of any transaction relating to the property completed within the two preceding years in which any vendor of the property to the company or any person who is, or was at the time of the transaction, a promoter or a director or proposed director of the company had any interest direct or indirect.

(2) The property to which this paragraph applies is property purchased or acquired by the company or proposed so to be purchased or acquired, which is to be paid for wholly or partly out of the proceeds of the issue offered for subscription by the prospectus or the purchase or acquisition of which has not been completed at the date of the issue of the prospectus, other than property—

- (a) the contract for the purchase or acquisition whereof was entered into in the ordinary course of the company's business, the contract not being made in contemplation of the issue nor the issue in consequence of the contract; or
- (b) as respects which the amount of the purchase money is not material.

10. The amount, if any, paid or payable as purchase money in cash, shares or debentures for any property to which the last foregoing paragraph applies, specifying the amount, if any, payable for goodwill.

11. The amount, if any, paid within the two preceding years, or payable, as commission (but not including commission to sub-underwriters) for subscribing or agreeing to subscribe, or procuring or agreeing to procure subscriptions, for any shares in or debentures of the company, or the rate of any such commission.

12. The amount or estimated amount of preliminary expenses and the persons by whom any of those expenses have been paid or are payable, and the amount or estimated amount of the expenses of the issue and the persons by whom any of those expenses have been paid or are payable.

13. Any amount or benefit paid or given within the two preceding years or intended to be paid or given to any promoter, and the consideration for the payment or the giving of the benefit.

14. The dates of, parties to and general nature of every material contract, not being a contract entered into in the ordinary course of the business carried on or intended to be carried on by the company or a contract entered into more than two years before the date of issue of the prospectus.

15. The names and addresses of the auditors, if any, of the company.

16. Full particulars of the nature and extent of the interest, if any, of every director in the promotion of, or in the property proposed to be acquired by, the company, or, where the interest of such a director consists in being a partner in a firm, the nature and extent of the interest of the firm, with a statement of all sums paid or agreed to be paid to him or to the firm in cash or shares or otherwise by any person either to induce him to become, or to qualify him as, a director, or otherwise for services rendered by him or by the firm in connection with the promotion or formation of the company.

17. If the prospectus invites the public to subscribe for shares in the company and the share capital of the company is divided into different classes of shares, the right of voting at meetings of the company conferred by, and the rights in respect of capital and dividends attached to, the several classes of shares respectively.

18. In the case of a company which has been carrying on business, or of a business which has been carried on for less than three years, the length of time during which the business of the company or the business to be acquired, as the case may be, has been carried on.

PART II

REPORTS TO BE SET OUT

19.—(1) A report by the auditors of the company with respect to—

- (a) profits and losses and assets and liabilities, in accordance with sub-paragraph (2) or (3) of this paragraph, as the case requires; and
- (b) the rates of the dividends, if any, paid by the company in respect of each class of shares in the company in respect of each of the five financial years immediately preceding the issue of the prospectus, giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years;

and, if no accounts have been made up in respect of any part of the period of five years ending on a date three months before the issue of the prospectus, containing a statement of that fact.

(2) If the company has no subsidiaries, the report shall—

- (a) so far as regards profits and losses, deal with the profits or losses of the company in respect of each of the five financial years immediately preceding the issue of the prospectus; and
- (b) so far as regards assets and liabilities, deal with the assets and liabilities of the company at the last date to which the accounts of the company were made up.

(3) If the company has subsidiaries, the report shall—

- (a) so far as regards profits and losses, deal separately with the company's profits or losses as provided by the last foregoing sub-paragraph, and in addition, deal either—

(i) as a whole with the combined profits or losses of its subsidiaries, so far as they concern members of the company; or

(ii) individually with the profits or losses of each subsidiary, so far as they concern members of the company;

or, instead of dealing separately with the company's profits or losses, deal as a whole with the profits or losses of the company and, so far as they concern members of the company, with the combined profits or losses of its subsidiaries; and

- (b) so far as regards assets and liabilities, deal separately with the company's assets and liabilities as provided by the last foregoing sub-paragraph and, in addition, deal either—

(i) as a whole with the combined assets and liabilities of its subsidiaries, with or without the company's assets and liabilities; or

(ii) individually with the assets and liabilities of each subsidiary;

and shall indicate as respects the assets and liabilities of the subsidiaries the allowance to be made for persons other than members of the company.

20. If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of any business, a report made by accountants (who shall be named in the prospectus) upon—

- (a) the profits or losses of the business in respect of each of the five financial years immediately preceding the issue of the prospectus; and
- (b) the assets and liabilities of the business at the last date to which the accounts of the business were made up.

21.—(1) If—

- (a) the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in any manner resulting in the acquisition by the company of shares in any other body corporate; and

- (b) by reason of that acquisition or anything to be done in consequence thereof or in connection therewith that body corporate will become a subsidiary of the company;

a report made by accountants (who shall be named in the prospectus) upon—

- (i) the profits or losses of the other body corporate in respect of each of the five financial years immediately preceding the issue of the prospectus; and

- (ii) the assets and liabilities of the other body corporate at the last date to which the accounts of the body corporate were made up.
- (2) The said report shall—
- (a) indicate how the profits or losses of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company and what allowance would have fallen to be made, in relation to assets and liabilities so dealt with, for holders of other shares, if the company had at all material times held the shares to be acquired; and
- (b) where the other body corporate has subsidiaries deal with the profits or losses and the assets and liabilities of the body corporate and its subsidiaries in the manner provided by sub-paragraph (3) of paragraph 19 of this Schedule in relation to the company and its subsidiaries.

PART III

PROVISIONS APPLYING TO PARTS I AND II OF SCHEDULE

22. Paragraphs 2, 3, 12 (so far as it relates to preliminary expenses) and 16 of this Schedule shall not apply in the case of a prospectus issued more than two years after the date at which the company is entitled to commence business.

23. Every person shall for the purposes of this Schedule, be deemed to be a vendor who has entered into any contract, absolute or conditional, for the sale or purchase, or for any option of purchase, of any property to be acquired by the company, in any case where—

- (a) the purchase money is not fully paid at the date of the issue of the prospectus;
- (b) the purchase money is to be paid or satisfied wholly or in part out of the proceeds of the issue offered for subscription by the prospectus;
- (c) the contract depends for its validity or fulfilment on the result of that issue.

24. Where any property to be acquired by the company is to be taken on lease, this Schedule shall have effect as if the expression 'vendor' included the lessor, and the expression 'purchase money' included the consideration for the lease, and the expression 'sub-purchaser' included a sub-lessee.

25. References in paragraph 7 of this Schedule to subscribing for shares or debentures shall include acquiring them from a person to whom they have been allotted or agreed to be allotted with a view to his offering them for sale.

26. For the purposes of paragraph 9 of this Schedule where the vendors or any of them are a firm, the members of the firm shall not be treated as separate vendors.

27. If in the case of a company which has been carrying on business, or of a business which has been carried on for less than five years, the accounts of the company or business have only been made up in respect of four years, three years, two years or one year, Part II of this Schedule shall have effect as if references to four years, three years, two years or one year, as the case may be, were substituted for references to five years.

28. The expression 'financial year' in Part II of this Schedule means the year in respect of which the accounts of the company or of the business, as the case may be, are made up, and where by reason of any alteration of the date on which the financial year of the company or business terminates the accounts of the company or business have been made up for a period greater or less than a year, that greater or less period shall for the purpose of that Part of this Schedule be deemed to be a financial year.

29. Any report required by Part II of this Schedule shall either indicate by way of note any adjustments as respects the figures of any profits or losses or assets and liabilities dealt with by the report which appear to the persons making the report necessary or shall make those adjustments and indicate that adjustments have been made.

30. Any report by accountants required by Part II of this Schedule shall be made by accountants qualified under this Act for appointment as auditors of a company which is not an exempt private company and shall not be made by any accountant who is an officer or servant, or a partner of or in the employment of an officer or servant, of the company or of the company's subsidiary or holding company or of a subsidiary of the company's holding company; and for the purposes of this paragraph the expression 'officer' shall include a proposed director but not an auditor.

FIFTH SCHEDULE

FORM OF STATEMENT IN LIEU OF PROSPECTUS TO BE DELIVERED TO REGISTRAR BY A COMPANY WHICH DOES NOT ISSUE A PROSPECTUS OR WHICH DOES NOT GO TO ALLOTMENT ON A PROSPECTUS ISSUED, AND REPORTS TO BE SET OUT THEREIN

PART I

FORM OF STATEMENT AND PARTICULARS TO BE CONTAINED THEREIN

THE COMPANIES ACT, 1948

Statement in lieu of Prospectus delivered for registration by

[Insert the name of the company.]

Pursuant to Section 48 of the Companies Act, 1948

Delivered for registration by

The nominal share capital of the company.	£
Divided into	Shares of £ each. " " " "
Amount (if any) of above capital which consists of redeemable preference shares. The earliest date on which the company has power to redeem these shares. Names, descriptions and addresses of directors or proposed directors. If the share capital of the company is divided into different classes of shares, the right of voting at meetings of the company conferred by, and the rights in respect of capital and dividends attached to, the several classes of shares respectively.	Shares of £ each.
Number and amount of shares and debentures agreed to be issued as fully or partly paid up other wise than in cash. The consideration for the intended issue of those shares and debentures.	1. shares of £ fully paid. 2. shares upon which £ per share credited as paid. 3. debenture £ . 4. Consideration:
Number, description and amount of any shares or debentures which any person has or is entitled to be given an option to subscribe for, or to acquire from a person to whom they have been allotted or agreed to be allotted with a view to his offering them for sale. Period during which option is exercisable. Price to be paid for shares or debentures subscribed for or acquired under option. Consideration for option or right to option. Persons to whom option or right to option was given or, if given to existing shareholders or debenture-holders as such, the relevant shares or debentures.	1. shares of £ and debentures of £ 2. Until 3. 4. Consideration: 5. Names and addresses:
Names and addresses of vendors of property purchased or acquired, or proposed to be purchased or acquired by the company except where the contract for its purchase or acquisition was entered into in the ordinary course of the business intended to be carried on by the company or the amount of the purchase money is not material. Amount (in cash, shares or debentures) payable to each separate vendor.	
Amount (if any) paid or payable (in cash or shares or debentures) for any such property, specifying amount (if any) paid or payable for goodwill.	Total purchase price £ Cash £ Shares £ Debentures £ Goodwill £

Short particulars of any transaction relating to any such property which was completed within the two preceding years and in which any vendor to the company or any person who is, or was at the time thereof, a promoter, director or proposed director of the company had any interest direct or indirect.	
Amount (if any) paid or payable as commission for subscribing or agreeing to subscribe or procuring or agreeing to procure subscriptions for any shares or debentures in the company; or Rate of the commission	Amount paid. " payable. Rate per cent.
The number of shares, if any, which persons have agreed for a commission to subscribe absolutely.	
Estimated amount of preliminary expenses	£ .
By whom those expenses have been paid or are payable.	
Amount paid or intended to be paid to any promoter. Consideration for the payment.	Name of promoter: Amount £ . Consideration:
Any other benefit given or intended to be given to any promoter.	Name of promoter: Nature and value of benefit:
Consideration for giving of benefit.	Consideration:
Dates of, parties to and general nature of every material contract (other than contracts entered into in the ordinary course of the business intended to be carried on by the company or entered into more than two years before the delivery of this statement).	
Time and place at which the contracts or copies thereof may be inspected or (1) in the case of a contract not reduced into writing, a memorandum giving full particulars thereof, and (2) in the case of a contract wholly or partly in a foreign language, a copy of a translation thereof in English or embodying a translation in English of the parts in a foreign language, as the case may be, being a translation certified in the prescribed manner to be a correct translation.	
Names and addresses of the auditors of the company (if any).	
Full particulars of the nature and extent of the interest of every director in the promotion of or in the property proposed to be acquired by the company, or where the interest of such a director consists in being a partner in a firm, the nature and extent of the interest of the firm, with a statement of all sums paid or agreed to be paid to him or to the firm in cash or shares, or otherwise, by any person either to induce him to become, or to qualify him as, a director, or otherwise for services rendered by him or by the firm in connection with the promotion or formation of the company.	

(Signatures of the persons above-named as directors or proposed directors, or of their agents authorised in writing.)

Date,

.....

PART II

REPORTS TO BE SET OUT

1. Where it is proposed to acquire a business, a report made by accountants (who shall be named in the statement) upon—

- (a) the profits or losses of the business in respect of each of the five financial years immediately preceding the delivery of the statement to the registrar; and
- (b) the assets and liabilities of the business at the last date to which the accounts of the business were made up.

2.—(1) Where it is proposed to acquire shares in a body corporate which by reason of the acquisition or anything to be done in consequence thereof or in connection therewith will become a subsidiary of the company, a report made by accountants (who shall be named in the statement) with respect to the profits and losses and assets and liabilities of the other body corporate in accordance with sub-paragraph (2) or (3) of this paragraph, as the case requires, indicating how the profits or losses of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company, and what allowance would have fallen to be made, in relation to assets and liabilities so dealt with, for holders of other shares, if the company had at all material times held the shares to be acquired.

(2) If the other body corporate has no subsidiaries, the report referred to in the last foregoing sub-paragraph shall—

- (a) so far as regards profits and losses, deal with the profits or losses of the body corporate in respect of each of the five financial years immediately preceding the delivery of the statement to the registrar; and
- (b) so far as regards assets and liabilities, deal with the assets and liabilities of the body corporate at the last date to which the accounts of the body corporate were made up.

(3) If the other body corporate has subsidiaries, the report referred to in sub-paragraph (1) of this paragraph shall—

- (a) so far as regards profits and losses, deal separately with the other body corporate's profits or losses as provided by the last foregoing sub-paragraph, and in addition deal either—

- (i) as a whole with the combined profits or losses of its subsidiaries, so far as they concern members of the other body corporate; or
- (ii) individually with the profits or losses of each subsidiary, so far as they concern members of the other body corporate;

or, instead of dealing separately with the other body corporate's profits or losses, deal as a whole with the profits or losses of the other body corporate and, so far as they concern members of the other body corporate, with the combined profits or losses of its subsidiaries; and

- (b) so far as regards assets and liabilities, deal separately with the other body corporate's assets and liabilities as provided by the last foregoing sub-paragraph and, in addition, deal either—

- (i) as a whole with the combined assets and liabilities of its subsidiaries, with or without the other body corporate's assets and liabilities; or
- (ii) individually with the assets and liabilities of each subsidiary;

and shall indicate as respects the assets and liabilities of the subsidiaries the allowance to be made for persons other than members of the company.

PART III

PROVISIONS APPLYING TO PARTS I AND II OF THIS SCHEDULE

3. In this Schedule the expression 'vendor' includes a vendor as defined in Part III of the Fourth Schedule to this Act, and the expression 'financial year' has the meaning assigned to it in that Part of that Schedule.

4. If in the case of a business which has been carried on, or of a body corporate which has been carrying on business, for less than five years, the accounts of the business or body corporate have only been made up in respect of four years, three years, two years or one year, Part II of this Schedule shall have effect as if references to four years, three years, two years or one year, as the case may be, were substituted for references to five years.

5. Any report required by Part II of this Schedule shall either indicate by way of note any adjustments as respects the figures of any profits or losses or assets and liabilities dealt with by the report which appear to the persons making the report necessary or shall make those adjustments and indicate that adjustments have been made.

6. Any report by accountants required by Part II of this Schedule shall be made by accountants qualified under this Act for appointment as auditors of a company which is not an exempt private company and shall not be made by any accountant who is an officer or servant, or a partner of or in the employment of an officer or servant, of the company or of the company's subsidiary or holding company or of a subsidiary of the company's holding company; and for the purposes of this paragraph the expression 'officer' shall include a proposed director but not an auditor.

SIXTH SCHEDULE

CONTENTS AND FORM OF ANNUAL RETURN OF A COMPANY HAVING A SHARE CAPITAL

Certified copies of Accounts

Except where the company is either an exempt private company as defined by Section 129 (4) of the Companies Act, 1948, which sends with this return a certificate in the form set out below or an assurance company which has complied with the provisions of Section 7 (4) of the Assurance Companies Act, 1909, there must be annexed to this return a written copy, certified both by a director and by the secretary of the company to be a true copy, of every balance sheet laid before the company in general meeting during the period to which this return relates (including every document required by law to be annexed to the balance sheet) and a copy (certified as aforesaid) of the report of the auditors on, and of the report of the directors accompanying, each such balance sheet. If any such balance sheet or document required by law to be annexed thereto is in a foreign language there must also be annexed to that balance sheet a translation in English of the balance sheet or document certified in the prescribed manner to be a correct translation. If any such balance sheet as aforesaid or document required by law to be annexed thereto did not comply with the requirements of the law as in force at the date of the audit with respect to the form of balance sheets or documents aforesaid, as the case may be, there must be made such additions to and corrections in the copy as would have been required to be made in the balance sheet or document in order to make it comply with the said requirements, and the fact that the copy has been so amended must be stated thereon.

Additional Certificate to be given in the case of an Exempt Private Company by the Persons signing the above-mentioned Certificates

We certify that, to the best of our knowledge and belief, the conditions mentioned in subsection (2) of Section 129 of the Companies Act, 1948, are satisfied at the date of this return and have been satisfied at all times since.....*

Signed....., Director.

Signed....., Secretary.

Banking Companies

A banking company, in order to avail itself of the benefit of Section 432 of the Companies Act, 1948, must add to this return a statement of the names of the several places where it carries on business.

* Insert '1st July, 1948' (the date of the commencement of the Companies Act, 1948) or if the company was registered after that date, the date on which it was registered, or, if the proviso is to Section 129 (1) of the Companies Act, 1948, has effect in relation to the return, the time at which it was shown to the Board of Trade that the conditions mentioned in the certificate were satisfied.

SEVENTH SCHEDULE

CONDITIONS AS TO INTERESTS IN SHARES AND DEBENTURES OF EXEMPT
PRIVATE COMPANY*Basic Conditions*

1. The basic conditions as to the shares or debentures of the company whose exemption is in question are—

- (a) that no body corporate is the holder of any of the shares or debentures; and
- (b) that no person other than the holder has any interest in any of the shares or debentures;

but these conditions are subject to the exceptions provided for by the following paragraphs of this Schedule.

Exceptions for normal Dealings of a business Nature

2.—(1) The rules contained in the following sub-paragraphs of this paragraph shall apply for the purposes both of the basic conditions and of the exceptions from those conditions.

(2) Where any share or debenture or any interest in any share or debenture is subject to a charge in favour of a banking or finance company by way of security for the purposes of a transaction entered into in the ordinary course of its business as such—

- (a) any interest under the charge, whether of the banking or finance company or a nominee for it, shall be disregarded; and
- (b) if the banking or finance company or its nominee is the holder of the share or debenture, the person entitled to the equity of redemption shall be treated as the holder, whether he has a present right to redeem or not.

(3) Any interest under a contract for the transfer of any share or debenture or of any interest in any share or debenture shall, until execution of an instrument of transfer by the parties, be disregarded unless execution thereof is unreasonably delayed.

(4) Subject to sub-paragraph (2) of this paragraph, on execution of an instrument of transfer of a share or debenture, the transferee and not the transferor shall be treated as the holder, notwithstanding that the transfer requires registration with the company, unless registration is refused.

(5) Any interest of the company itself in any of its shares or debentures, and any lien or charge arising by operation of law and affecting any of the shares or debentures shall be disregarded.

Exceptions for Cases of Death and for family Settlements

3.—(1) The basic conditions shall be subject to exceptions for—

- (a) any shares or debentures forming part of the estate of a deceased holder thereof, so long as administration of his estate has not been completed; and
- (b) any shares or debentures held by trustees on the trusts of a will or family settlement disposing of the shares or debentures, so long as no body corporate has for the time being any immediate interest under the said trusts other than—
 - (i) a body corporate established for charitable purposes only and having no right to exercise or control the exercise of any part of the voting power at any general meeting of the company;
 - (ii) a body corporate which is a trustee of the said trusts and has such an interest only by way of remuneration for acting as trustee thereof.

(2) For the purposes of this paragraph—

- (a) shares or debentures held by trustees on trusts arising on an intestacy shall, if the shares or debentures or an interest therein formed part of the intestate's estate at the time of his death, be treated as if the trusts arose under a will disposing of the shares or debentures;
- (b) the expression 'family settlement' means a settlement made either—
 - (i) in consideration or contemplation of an intended marriage of the settlor or any of the settlor's issue or in pursuance of a contract entered into in consideration or contemplation of any such marriage; or

- (ii) otherwise in favour of any of the following persons, that is to say the settlor, his parents and grandparents, and any other individual who at the date of the settlement is a member of the company or, in the case of a settlement of debentures, a member or debenture-holder of the company, and the wife or husband and issue, and the wife or husband of any of the issue, of the settlor, his parents, or any such other individual, and persons taking in the event of a failure of the issue or any class of the issue of any person taking under the settlement;
- (c) the expressions 'parent', 'grandparent' and 'issue' shall be construed as if the stepchild, adopted child or illegitimate child of any person were that person's child;
- (d) any reference to a wife or husband shall include a former wife or husband and a reputed wife or husband;
- (e) the expression 'will' includes any testamentary disposition;
- (f) any reference to a will or family settlement disposing of any shares or debentures shall include a will or family settlement disposing of an interest under another will or family settlement disposing of the shares or debentures.

Exception for Cases of Disability

4. Where the person entitled to any share or debenture or any interest in any share or debenture is of unsound mind or otherwise under any disability, and by reason thereof the share, debenture or interest is vested in an administrator, curator or other person on behalf of the person entitled thereto, then in relation to the share, debenture or interest the person in whom it is so vested and the person entitled thereto shall be treated for the purposes of this Schedule as if they were the same person.

Exception for Trusts for Employees

5. The basic conditions shall be subject to an exception for any shares or debentures held by trustees for the purposes of a scheme maintained for the benefit of employees of the company, including any director holding a salaried employment or office in the company.

Exception for Shares held by Exempt Private Companies

6.—(1) The first of the basic conditions shall be subject to an exception for shares held by another private company which is itself an exempt private company:

Provided that this exception shall not apply, if, taking all the following companies together, that is to say—

- (a) the company whose exemption is in question (hereafter in this Schedule referred to as 'the relevant company');
- (b) any company holding shares to which this exception has to be applied in determining the relevant company's right to be treated as an exempt private company; and
- (c) any further company taken into account for the purposes of this proviso in determining the right to be so treated of any company holding any such shares as aforesaid;

the total number of persons holding shares in those companies is more than fifty, joint shareholders being treated as a single person and the companies themselves and (subject to sub-paragraph (4) of this paragraph) their employees and former employees being disregarded.

(2) Where the relevant company and another company hold shares in each other, the other company shall be treated for the purposes of the foregoing sub-paragraph as an exempt private company if—

- (a) in determining its right to be so treated the exception in that sub-paragraph would apply to the shares in it held by the relevant company, on the assumption that the relevant company was an exempt private company; and

(b) in all other respects the other company is entitled to be so treated; and where another company's right to be so treated depends on the application to any shares in it of that sub-paragraph, and the application thereof to those shares depends indirectly on the relevant company's right to be so treated, this sub-paragraph shall apply as if those shares were held by the relevant company.

(3) Where by virtue of this paragraph any shares are excepted from the first of the basic conditions, the second of those conditions shall be subject to an exception for any interest in those shares which any person has by virtue of debentures of the company holding those shares, or as trustee of a deed for securing an issue of debentures of that company.

(4) In the proviso to sub-paragraph (1) of this paragraph, the direction that employees and former employees of the companies shall be disregarded in computing the number of shareholders shall not apply to a person holding shares in a company of which he is not for the time being an employee unless, having been formerly in the employment of that company, he held, while in that employment, and has continued after the determination of that employment to hold, shares in that company.

Exception for Banking or Finance Company providing Capital

7.—(1) The first of the basic conditions shall be subject to an exception for any shares or debentures held by or by a nominee for a banking or finance company, where the banking or finance company acquired the shares or debentures or its interest therein in the ordinary course of its business as such and by arrangement with the relevant company or its promoters:

Provided that this exception shall not apply if the banking or finance company has the right (or, where there is more than one such company holding shares or debentures to which this exception has to be applied in determining the relevant company's right to be treated as an exempt private company, they have between them the right) to exercise or control the exercise of one-fifth or more of the total voting power at any general meeting of the relevant company.

(2) Where by virtue of the foregoing sub-paragraph any shares or debentures are excepted from the first of the basic conditions, the second of those conditions shall be subject to an exception for the banking or finance company itself, where the shares or debentures are held by a nominee for it, and for any interest in those shares or debentures which any person has by virtue of debentures of the banking or finance company or as trustee of a deed for securing an issue of debentures of that company.

Exceptions for Bankruptcies, Liquidations, &c.

8. The basic conditions shall be subject to exceptions for—

- (a) any shares or debentures forming part of the assets in a bankruptcy or liquidation of a holder thereof; and
- (b) any shares or debentures held either—
 - (i) on trusts created for the benefit of his creditors generally by a person having an interest therein; or
 - (ii) otherwise for the purposes of any composition or scheme made or approved under any Act by a Court or an officer of a Court for arranging the affairs of such a person.

Meaning of 'Banking or Finance Company'

9. In this Schedule the expression 'banking or finance company' means any body corporate or partnership whose ordinary business includes the business of banking and any other body corporate whose ordinary business includes the business of lending money or of subscribing for shares or debentures, except that it does not include any such other body corporate unless either—

- (a) its shares are quoted or dealt in on a recognised stock exchange; or
- (b) it is designated for the purposes of this paragraph by order of the Board of Trade; or
- (c) it is a subsidiary of a body corporate whose shares are so quoted or dealt in or which is so designated

EIGHTH SCHEDULE

ACCOUNTS

PRELIMINARY

1. Paragraphs 2 to 11 of this Schedule apply to the balance sheet and 12 to 14 to the profit and loss account, and are subject to the exceptions and modifications provided for by Part II of this Schedule in the case of a holding company and by Part III thereof in the case of companies of the classes there mentioned; and this Schedule has effect in addition to the provisions of Sections 196 and 197 of this Act.

PART I

GENERAL PROVISIONS AS TO BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

Balance Sheet

2. The authorised share capital, issued share capital, liabilities and assets shall be summarised, with such particulars as are necessary to disclose the general nature of the assets and liabilities, and there shall be specified—

- (a) any part of the issued capital that consists of redeemable preference shares, and the earliest date on which the company has power to redeem those shares;
- (b) so far as the information is not given in the profit and loss account, any share capital on which interest has been paid out of capital during the financial year, and the rate at which interest has been so paid;
- (c) the amount of the share premium account;
- (d) particulars of any redeemed debentures which the company has power to re-issue.

3. There shall be stated under separate headings, so far as they are not written off—

- (a) the preliminary expenses;
- (b) any expenses incurred in connection with any issue of share capital or debentures;
- (c) any sums paid by way of commission in respect of any shares or debentures;
- (d) any sums allowed by way of discount in respect of any debentures; and
- (e) the amount of the discount allowed on any issue of shares at a discount.

4.—(1) The reserves, provisions, liabilities and fixed and current assets shall be classified under headings appropriate to the company's business:

Provided that—

- (a) where the amount of any class is not material, it may be included under the same heading as some other class; and
 - (b) where any assets of one class are not separable from assets of another class, those assets may be included under the same heading.
- (2) Fixed assets shall also be distinguished from current assets.

(3) The method or methods used to arrive at the amount of the fixed assets under each heading shall be stated.

5.—(1) The method of arriving at the amount of any fixed asset shall, subject to the next following sub-paragraph, be to take the difference between—

- (a) its cost or, if it stands in the company's books at a valuation, the amount of the valuation; and
- (b) the aggregate amount provided or written off since the date of acquisition or valuation, as the case may be, for depreciation or diminution in value;

and for the purposes of this paragraph the net amount at which any assets stand in the company's books at the commencement of this Act (after deduction of the amounts previously provided or written off for depreciation or diminution in value) shall, if the figures relating to the period before the commencement of this Act cannot be obtained without unreasonable expense or delay, be treated as if it were the amount of a valuation of those assets made at the commencement of this Act and, where any of those assets are sold, the said net amount less the amount of the sales shall be treated as if it were the amount of a valuation so made of the remaining assets.

- (2) The foregoing sub-paragraph shall not apply—
- (a) to assets for which the figures relating to the period beginning with the commencement of this Act cannot be obtained without unreasonable expense or delay; or
- (b) to assets the replacement of which is provided for wholly or partly—
- (i) by making provision for renewals and charging the cost of replacement against the provision so made; or
 - (ii) by charging the cost of replacement direct to revenue; or
- (c) to any investments of which the market value (or, in the case of investments not having a market value, their value as estimated by the directors) is shown either as the amount of the investments or by way of note; or
- (d) to goodwill, patents or trade marks.
- (3) For the assets under each heading whose amount is arrived at in accordance with sub-paragraph (1) of this paragraph, there shall be shown
- (a) the aggregate of the amounts referred to in paragraph (a) of that sub-paragraph; and
 - (b) the aggregate of the amounts referred to in paragraph (b) thereof.
- (4) As respects the assets under each heading whose amount is not arrived at in accordance with the said sub-paragraph (1) because their replacement is provided for as mentioned in sub-paragraph (2) (b) of this paragraph, there shall be stated—
- (a) the means by which their replacement is provided for; and
 - (b) the aggregate amount of the provision (if any) made for renewals and not used.
6. The aggregate amounts respectively of capital reserves, revenue reserves and provisions (other than provisions for depreciation, renewals or diminution in value of assets) shall be stated under separate headings:

Provided that—

- (a) this paragraph shall not require a separate statement of any of the said three amounts which is not material; and
- (b) the Board of Trade may direct that it shall not require a separate statement of the amount of provisions where they are satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived at after taking into account a provision (other than as aforesaid) shall be so framed or marked as to indicate that fact.

7.—(1) There shall also be shown (unless it is shown in the profit and loss account or a statement or report annexed thereto, or the amount involved is not material)—

- (a) where the amount of the capital reserves, of the revenue reserves or of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) shows an increase as compared with the amount at the end of the immediately preceding financial year, the source from which the amount of the increase has been derived; and
- (b) where—
 - (i) the amount of the capital reserves or of the revenue reserves shows a decrease as compared with the amount at the end of the immediately preceding financial year; or
 - (ii) the amount at the end of the immediately preceding financial year of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) exceeded the aggregate of the sums since applied and amounts still retained for the purposes thereof;
 the application of the amounts derived from the difference.

(2) Where the heading showing any of the reserves or provisions aforesaid is divided into sub-headings, this paragraph shall apply to each of the separate amounts shown in the sub-headings instead of applying to the aggregate amount thereof.

8.—(1) There shall be shown under separate headings—

- (a) the aggregate amounts respectively of the company's trade investments,

quoted investments other than trade investments and unquoted investments other than trade investments;

- (b) if the amount of the goodwill and of any patents and trade marks or part of that amount is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the said amount so shown or ascertained so far as not written off or, as the case may be, the said amount so far as it is so shown or ascertainable and as so shown or ascertained, as the case may be;
- (c) the aggregate amount of any outstanding loans made under the authority of provisos (b) and (c) of subsection (1) of Section 54 of this Act;
- (d) the aggregate amount of bank loans and overdrafts;
- (e) the net aggregate amount (after deduction of income-tax) which is recommended for distribution by way of dividend.

(2) Nothing in head (b) of the foregoing sub-paragraph shall be taken as requiring the amount of the goodwill, patents and trade marks to be stated otherwise than as a single item.

(3) The heading showing the amount of the quoted investments other than trade investments shall be sub-divided, where necessary, to distinguish the investments as respects which there has, and those as respects which there has not, been granted a quotation or permission to deal on a recognised stock exchange.

9. Where any liability of the company is secured otherwise than by operation of law on any assets of the company, the fact that that liability is so secured shall be stated, but it shall not be necessary to specify the assets on which the liability is secured.

10. Where any of the company's debentures are held by a nominee of or trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated.

11.—(1) The matters referred to in the following sub-paragraphs shall be stated by way of note, or in a statement or report annexed, if not otherwise shown.

(2) The number, description and amount of any shares in the company which any person has an option to subscribe for, together with the following particulars of the option, that is to say—

- (a) the period during which it is exercisable;
- (b) the price to be paid for shares subscribed for under it.

(3) The amount of any arrears of fixed cumulative dividends on the company's shares and the period for which the dividends or, if there is more than one class, each class of them are in arrear, the amount to be stated before deduction of income-tax, except that, in the case of tax-free dividends, the amount shall be shown free of tax and the fact that it is so shown shall also be stated.

(4) Particulars of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secured.

(5) The general nature of any other contingent liabilities not provided for and, where practicable, the aggregate amount or estimated amount of those liabilities, if it is material.

(6) Where practicable the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for.

(7) If in the opinion of the directors any of the current assets have not a value, on realisation in the ordinary course of the company's business, at least equal to the amount at which they are stated, the fact that the directors are of that opinion.

(8) The aggregate market value of the company's quoted investments, other than trade investments, where it differs from the amount of the investments as stated, and the stock exchange value of any investments of which the market value is shown (whether separately or not) and is taken as being higher than their stock exchange value.

(9) The basis on which foreign currencies have been converted into sterling, where the amount of the assets or liabilities affected is material.

(10) The basis on which the amount, if any, set aside for United Kingdom income-tax is computed.

(11) Except in the case of the first balance sheet laid before the company after the commencement of this Act, the corresponding amounts at the end of the immediately preceding financial year for all items shown in the balance sheet.

Profit and Loss Account

12.—(1) There shall be shown—

- (a) the amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets;
- (b) the amount of the interest on the company's debentures and other fixed loans;
- (c) the amount of the charge for United Kingdom income-tax and other United Kingdom taxation on profits, including, where practicable, as United Kingdom income-tax any taxation imposed elsewhere to the extent of the relief, if any, from United Kingdom income-tax and distinguishing where practicable between income-tax and other taxation;
- (d) the amounts respectively provided for redemption of share capital and for redemption of loans;
- (e) the amount, if material, set aside or proposed to be set aside to, or withdrawn from, reserves;
- (f) subject to sub-paragraph (2) of this paragraph, the amount, if material, set aside to provisions other than provisions for depreciation, renewals or diminution in value of assets or, as the case may be, the amount, if material, withdrawn from such provisions and not applied for the purposes thereof;
- (g) the amount of income from investments, distinguishing between trade investments and other investments;
- (h) the aggregate amount of the dividends paid and proposed.

(2) The Board of Trade may direct that a company shall not be obliged to show an amount set aside to provisions in accordance with sub-paragraph (1) (f) of this paragraph, if the Board is satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived at after taking into account the amount set aside as aforesaid shall be so framed or marked as to indicate that fact.

13. If the remuneration of the auditors is not fixed by the company in general meeting, the amount thereof shall be shown under a separate heading, and for the purposes of this paragraph, any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression 'remuneration'.

14.—(1) The matters referred to in the following sub-paragraphs shall be stated by way of note, if not otherwise shown.

(2) If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for or the fact that it is not provided for, as the case may be.

(3) The basis on which the charge for United Kingdom income-tax is computed.

(4) Whether or not the amount stated for dividends paid and proposed is for dividends subject to deduction of income-tax.

(5) Except in the case of the first profit and loss account laid before the company after the commencement of this Act the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account.

(6) Any material respects in which any items shown in the profit and loss account are affected—

- (a) by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or
- (b) by any change in the basis of accounting.

PART II

SPECIAL PROVISIONS WHERE THE COMPANY IS A HOLDING OR SUBSIDIARY COMPANY

Modifications of and Additions to Requirements as to Company's own Accounts

15.—(1) This paragraph shall apply where the company is a holding company, whether or not it is itself a subsidiary of another body corporate.

(2) The aggregate amount of assets consisting of shares in, or amounts owing (whether on account of a loan or otherwise) from, the company's subsidiaries, distinguishing shares from indebtedness, shall be set out in the balance sheet separately from all the other assets of the company, and the aggregate amount of indebtedness (whether on account of a loan or otherwise) to the company's subsidiaries shall be so set out separately from all its other liabilities and—

- (a) the references in Part I of this Schedule to the company's investments shall not include investments in its subsidiaries required by this paragraph to be separately set out; and
- (b) paragraph 5, sub-paragraph (1) (a) of paragraph 12, and sub-paragraph (2) of paragraph 14 of this Schedule shall not apply in relation to fixed assets consisting of interests in the company's subsidiaries.

(3) There shall be shown by way of note on the balance sheet or in a statement or report annexed thereto the number, description and amount of the shares in and debentures of the company held by its subsidiaries or their nominees, but excluding any of those shares or debentures in the case of which the subsidiary is concerned as personal representative or in the case of which it is concerned as trustee and neither the company nor any subsidiary thereof is beneficially interested under the trust, otherwise than by way of security only for the purposes of a transaction entered into by it in the ordinary course of a business which includes the lending of money.

(4) Where group accounts are not submitted, there shall be annexed to the balance sheet a statement showing—

- (a) the reasons why subsidiaries are not dealt with in group accounts;
- (b) the net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts, of the subsidiaries' profits after deducting the subsidiaries' losses (or vice versa)—
 - (i) for the respective financial years of the subsidiaries ending with or during the financial year of the company; and
 - (ii) for their previous financial years since they respectively became the holding company's subsidiary;
- (c) the net aggregate amount of the subsidiaries' profits after deducting the subsidiaries' losses (or vice versa)—
 - (i) for the respective financial years of the subsidiaries ending with or during the financial year of the company; and
 - (ii) for their other financial years since they respectively became the holding company's subsidiary;
 so far as those profits are dealt with, or provision is made for those losses, in the company's accounts;
- (d) any qualifications contained in the report of the auditors of the subsidiaries on their accounts for their respective financial years ending as aforesaid, and any note or saving contained in those accounts to call attention to a matter which, apart from the note or saving, would properly have been referred to in such a qualification, in so far as the matter which is the subject of the qualification or note is not covered by the company's own accounts and is material from the point of view of its members;

or, in so far as the information required by this sub-paragraph is not obtainable, a statement that it is not obtainable:

Provided that the Board of Trade may, on the application or with the consent of the company's directors, direct that in relation to any subsidiary this sub-paragraph shall not apply or shall apply only to such extent as may be provided by the direction.

(5) Paragraphs (b) and (c) of the last foregoing sub-paragraph shall apply only to profits and losses of a subsidiary which may properly be treated in the

holding company's accounts as revenue profits or losses, and the profits or losses attributable to any shares in a subsidiary for the time being held by the holding company or any other of its subsidiaries shall not (for that or any other purpose) be treated as aforesaid so far as they are profits or losses for the period before the date on or as from which the shares were acquired by the company or any of its subsidiaries, except that they may in a proper case be so treated where—

- (a) the company is itself the subsidiary of another body corporate; and
- (b) the shares were acquired from that body corporate or a subsidiary of it;

and for the purpose of determining whether any profits or losses are to be treated as profits or losses for the said period the profit or loss for any financial year of the subsidiary may, if it is not practicable to apportion it with reasonable accuracy by reference to the facts, be treated as accruing from day to day during that year and be apportioned accordingly.

(6) Where group accounts are not submitted, there shall be annexed to the balance sheet a statement showing, in relation to the subsidiaries (if any) whose financial years did not end with that of the company—

- (a) the reasons why the company's directors consider that the subsidiaries' financial years should not end with that of the company; and
- (b) the dates on which the subsidiaries' financial years ending last before that of the company respectively ended or the earliest and latest of those dates.

16.—(1) The balance sheet of a company which is a subsidiary of another body corporate, whether or not it is itself a holding company, shall show the aggregate amount of its indebtedness to all bodies corporate of which it is a subsidiary or a fellow subsidiary and the aggregate amount of the indebtedness of all such bodies corporate to it, distinguishing in each case between indebtedness in respect of debentures and otherwise.

(2) For the purposes of this paragraph a company shall be deemed to be a fellow subsidiary of another body corporate if both are subsidiaries of the same body corporate but neither is the other's.

Consolidated Accounts of Holding Company and Subsidiaries

17. Subject to the following paragraphs of this Part of this Schedule, the consolidated balance sheet and profit and loss account shall combine the information contained in the separate balance sheets and profit and loss accounts of the holding company and of the subsidiaries dealt with by the consolidated accounts, but with such adjustments (if any) as the directors of the holding company think necessary.

18. Subject as aforesaid and to Part III of this Schedule, the consolidated accounts shall, in giving the said information, comply, so far as practicable, with the requirements of this Act as if they were the accounts of an actual company.

19. Sections 196 and 197 of this Act shall not, by virtue of the two last foregoing paragraphs, apply for the purpose of the consolidated accounts.

20. Paragraph 7 of this Schedule shall not apply for the purpose of any consolidated accounts laid before a company with the first balance sheet so laid after the commencement of this Act.

21. In relation to any subsidiaries of the holding company not dealt with by the consolidated accounts—

- (a) sub-paragraphs (2) and (3) of paragraph 15 of this Schedule shall apply for the purpose of those accounts as if those accounts were the accounts of an actual company of which they were subsidiaries; and
- (b) there shall be annexed the like statement as is required by sub-paragraph (4) of that paragraph, where there are no group accounts, but as if references therein to the holding company's accounts were references to the consolidated accounts.

22. In relation to any subsidiaries (whether or not dealt with by the consolidated accounts), whose financial years did not end with that of the company, there shall be annexed the like statement as is required by sub-paragraph (6) of paragraph 15 of this Schedule where there are no group accounts.

PART III

EXCEPTIONS FOR SPECIAL CLASSES OF COMPANY

23.—(1) A banking or discount company shall not be subject to the requirements of Part I of this Schedule other than—

- (a) as respects its balance sheet, those of paragraphs 2 and 3, paragraph 4 (so far as it relates to fixed and current assets), paragraph 8 (except sub-paragraph (1) (d)), paragraphs 9 and 10, and paragraph 11 (except sub-paragraph (8)); and
- (b) as respects its profit and loss account, those of sub-paragraph (1) (h) of paragraph 12, paragraph 13 and sub-paragraphs (1), (4) and (5) of paragraph 14;

but, where in its balance sheet capital reserves, revenue reserves or provisions (other than provisions for depreciation, renewals or diminution in value of assets) are not stated separately, any heading stating an amount arrived at after taking into account such a reserve or provision shall be so framed or marked as to indicate that fact, and its profit and loss account shall indicate by appropriate words the manner in which the amount stated for the company's profit or loss has been arrived at.

(2) The accounts of a banking or discount company shall not be deemed, by reason only of the fact that they do not comply with any requirements of the said Part I from which the company is exempt by virtue of this paragraph, not to give the true and fair view required by this Act.

(3) In this paragraph the expression 'banking or discount company' means any company which satisfies the Board of Trade that it ought to be treated for the purposes of this Schedule as a banking company or as a discount company.

24.—(1) In relation to an assurance company within the meaning of the Assurance Companies Acts, 1909 to 1946, which is subject to and complies with the requirements of those Acts as respects the preparation and deposit with the Board of Trade of a balance sheet and profit and loss account, the foregoing paragraph shall apply as it applies in relation to a banking or discount company, and such an assurance company shall also not be subject to the requirements of sub-paragraphs (1) (a) and (3) of paragraph 8 and sub-paragraphs (4) to (7) and sub-paragraph (10) of paragraph 11 of this Schedule:

Provided that the Board of Trade may direct that any such assurance company whose business includes to a substantial extent business other than assurance business shall comply with all the requirements of the said Part I or such of them as may be specified in the direction and shall comply therewith as respects either the whole of its business or such part thereof as may be so specified.

(2) Where an assurance company is entitled to the benefit of this paragraph, then any wholly owned subsidiary thereof shall also be so entitled if its business consists only of business which is complementary to assurance business of the classes carried on by the assurance company.

(3) For the purposes of this paragraph a company shall be deemed to be the wholly owned subsidiary of an assurance company if it has no members except the assurance company and the assurance company's wholly owned subsidiaries and its or their nominees.

25.—(1) A company to which this paragraph applies shall not be subject to the following requirements of this Schedule, that is to say—

- (a) as respects its balance sheet, those of paragraph 4 (except so far as the said paragraph relates to fixed and current assets) and paragraphs 5, 6 and 7; and
- (b) as respects its profit and loss account, those of sub-paragraph (1) (a), (e) and (f) of paragraph 12;

but a company taking advantage of this paragraph shall be subject, instead of the said requirements, to any prescribed conditions as respects matters to be stated in its accounts or by way of note thereto and as respects information to be furnished to the Board of Trade or a person authorised by them to require it.

(2) The accounts of a company shall not be deemed, by reason only of the fact that they do not comply with any requirements of Part I of this Schedule

from which the company is exempt by virtue of this paragraph, not to give the true and fair view required by this Act.

(3) This paragraph applies to companies of any class prescribed for the purposes thereof, and a class of companies may be so prescribed if it appears to the Board of Trade desirable in the national interest:

Provided that, if the Board of Trade are satisfied that any of the conditions prescribed for the purposes of this paragraph has not been complied with in the case of any company, they may direct that so long as the direction continues in force this paragraph shall not apply to the company.

26. Where a company entitled to the benefit of any provision contained in this Part of this Schedule is a holding company, the reference in Part II of this Schedule to consolidated accounts complying with the requirements of this Act shall, in relation to consolidated accounts of that company, be construed as referring to those requirements in so far only as they apply to the separate accounts of that company.

PART IV,

INTERPRETATION OF SCHEDULE

27.—(1) For the purposes of this Schedule, unless the context otherwise requires—

- (a) the expression 'provision' shall, subject to sub-paragraph (2) of this paragraph, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;
- (b) the expression 'reserve' shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;
- (c) the expression 'capital reserve' shall not include any amount regarded as free for distribution through the profit and loss account and the expression 'revenue reserve' shall mean any reserve other than a capital reserve;

and in this paragraph the expression 'liability' shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where—

- (a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or
- (b) any amount retained by way of providing for any known liability;

is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision.

28. For the purposes aforesaid, the expression 'quoted investment' means an investment as respects which there has been granted a quotation or permission to deal on a recognised stock exchange, or on any stock exchange of repute outside Great Britain, and the expression 'unquoted investment' shall be construed accordingly.

NINTH SCHEDULE

MATTERS TO BE EXPRESSLY STATED IN AUDITORS' REPORT

1. Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit.

2. Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.

3.—(1) Whether the company's balance sheet and (unless it is framed as a consolidated profit and loss account) profit and loss account dealt with by the report are in agreement with the books of account and returns.

(2) Whether, in their opinion and to the best of their information and according to the explanations given them, the said accounts give the information required by this Act in the manner so required and give a true and fair view—

- (a) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and
- (b) in the case of the profit and loss account, of the profit or loss for its financial year;

or, as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Eighth Schedule to this Act are not required to be disclosed.

4. In the case of a holding company submitting group accounts whether, in their opinion, the group accounts have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company, or, as the case may be, so as to give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Eighth Schedule to this Act are not required to be disclosed.

PARLIAMENTARY COMPANIES

THE COMPANIES CLAUSES CONSOLIDATION ACT, 1845

8 *Vict. Ch. 16*

Register of Shareholders

9. The company shall keep a book to be called the 'Register of Shareholders', and in such book shall be fairly and distinctly entered, from time to time, the names of the several corporations, and the names and addresses of the several persons entitled to shares in the company, together with the number of shares to which such shareholders shall be respectively entitled, distinguishing each share by its number and the amount of the subscriptions paid on such shares, and the surnames or corporate names of the said shareholders shall be placed in alphabetical order; and such book shall be authenticated by the common seal of the company being affixed thereto; and such authentication shall take place at the first ordinary meeting, or at the next subsequent meeting of the company, and so from time to time at each ordinary meeting of the company.

Addresses of Shareholders

10. In addition to the said Register of Shareholders, the company shall provide a book to be called the 'Shareholders' Address Book', in which the secretary shall, from time to time, enter in alphabetical order the corporate names and places of business of the several shareholders of the company, being corporations, and the surnames, of the several other shareholders, with their respective Christian names, places of abode, and descriptions, so far as the same shall be known to the company.

Register of Mortgages and Bonds

45. A register of mortgages and bonds shall be kept by the secretary, and within fourteen days after the date of any such mortgage or bond an entry or memorial, specifying the number and date of such mortgage or bond and the sums secured thereby, and the names of the parties thereto, with their proper additions, shall be made in such register.

Register of Stock

63. The company shall, from time to time, cause the names of the several parties who may be interested in any such stock as aforesaid, with the amount of the interest therein possessed by them respectively, to be entered in a book to be kept for the purpose and to be called 'The Register of Holders of Consolidated Stock'.

Election of Auditors

101. Except where, by the special Act, auditors shall be directed to be appointed otherwise than by the company, the company shall, at the first ordinary meeting after the passing of the special Act, elect the prescribed number of auditors, and, if no number is prescribed, two auditors, in like manner as is provided for the election of directors; and at the first ordinary meeting of the company in each year thereafter the company shall in like manner elect an auditor to supply the place of the auditor then retiring from office, according to the provision hereinafter contained; and every auditor elected as hereinbefore provided, being neither removed nor disqualified nor having resigned, shall continue to be an auditor until another be elected in his stead.

102. Where no other qualification shall be prescribed by the special Act, every auditor shall have at least one share in the undertaking; and he shall not hold any office in the company, nor be in any other manner interested in its concerns except as a shareholder.

103. One of such auditors (to be determined in the first instance by ballot between themselves, unless they shall otherwise agree, and afterwards by seniority) shall go out of office at the first ordinary meeting in each year; but the auditor so going out shall be immediately re-eligible, and after any such re-election shall, with respect to the going out of office of rotation, be deemed a new auditor.

104. If any vacancy take place among the auditors in the course of the current year, then, at any general meeting of the company, the vacancy may, if the company think fit, be supplied by election of the shareholders.

105. The provision of this Act respecting the failure of an ordinary meeting at which directors ought to be chosen shall apply, *mutatis mutandis*, to any ordinary meeting at which an auditor ought to be appointed.

Powers and Duties of Auditors

106. The directors shall deliver to such auditors the half-yearly or other periodical accounts and balance sheet fourteen days at the least before the ensuing ordinary meeting at which the same are required to be produced to the shareholders, as hereinafter provided.

107. It shall be the duty of such auditors to receive from the directors the half-yearly or other periodical accounts and balance sheet required to be presented to the shareholders, and to examine the same.

108. It shall be lawful for the auditors to employ such accountants and other persons as they may think proper, at the expense of the company, and they shall either make a special report on the said accounts or simply confirm the same; and such report or confirmation shall be read, together with the report of the directors, at the ordinary meeting.

Accounts

115. The directors shall cause full and true accounts to be kept of all sums of money received or expended on account of the company by the directors and all persons employed by or under them, and of the matters and things for which such sums of money shall have been received or disbursed and paid.

116. The books of the company shall be balanced at the prescribed periods, and, if no periods be prescribed, fourteen days at least before each ordinary meeting; and, forthwith, on the books being so balanced, an exact balance sheet shall be made up, which shall exhibit a true statement of the capital, stock, credits, and property of every description belonging to the company, and the debts due by the company at the date of making such balance sheet, and a distinct view of the profit or loss which shall have arisen on the transactions of the company in the course of the preceding half-year; and previously to each ordinary meeting such balance sheet shall be examined by the directors, or any three of their number, and shall be signed by the chairman or deputy-chairman of the directors.

118. The directors shall produce to the shareholders assembled at such ordinary meeting the said balance sheet, applicable to the period immediately preceding such meeting, together with the report of the auditors thereon, as hereinbefore provided.

Dividends

120. Previously to every ordinary meeting at which a dividend is intended to be declared, the directors shall cause a scheme to be prepared showing the profits (if any) of the company for the period current since the preceding ordinary meeting at which a dividend was declared, and apportioning the same, or so much thereof as they may consider applicable to the purposes of dividend, among the shareholders, according to the shares held by them respectively, the amount paid thereon, and the periods during which the same may have been paid, and shall exhibit such scheme at such ordinary meeting, and at such meeting a dividend may be declared according to such scheme.

121. The company shall not make any dividend whereby their capital stock will be in any degree reduced: provided always that the word 'dividend' shall not be construed to apply to a return of any portion of the capital stock, with the consent of all the mortgagees and bond creditors of the company, due notice being given for that purpose at an extraordinary meeting to be convened for that object.

122. Before apportioning the profits to be divided among the shareholders the directors may, if they think fit, set aside thereout such sum as they may think proper to meet contingencies, or for enlarging, repairing, or improving the works connected with the undertaking, or any part thereof, and may divide the balance only among the shareholders.

123. No dividend shall be paid in respect of any share, until all calls then due in respect of that and every other share held by the person to whom such dividend may be payable shall have been paid.

THE COMPANIES CLAUSES ACT, 1863

26 & 27 Vict. Ch. 118

Issues of Preference Shares and Stock

13. Where any such company is authorised by any special Act hereafter passed and incorporating this part of this Act to raise any additional sum or sums by the issue of new preference shares, or by the issue of new preference stock, or (at the option of the company) by either of those modes, then and in every such case the company, with the like sanction as aforesaid, may for the purpose of raising such additional sum or sums from time to time create and issue (according as the authority given by the special Act extends to shares only or to stock only or to both) such new shares or new stock either ordinary or preference, and either of one class and with like privileges, or of several classes and with different privileges, and of the same or different amounts, and respectively with any fixed, fluctuating, contingent, preferential, perpetual, terminable, deferred, or other dividend or interest, not exceeding the rate prescribed in the special Act; and if no rate is prescribed, then not exceeding the rate of five pounds per centum per annum, and subject (as to any such new shares) to the payment of calls of such amounts and at such times as the company from time to time thinks fit.

Provided always that any preference assigned to any shares or stock so issued under the special Act shall not affect any guarantee or any preference or priority in the payment of dividend or interest on any shares or stock that may have been granted by the company under or confirmed by any previous Act, or that may be otherwise lawfully subsisting.

Preference Dividends not Cumulative

14. The preference shares or preference stock shall be entitled to the preferential dividend, or interest assigned thereto, out of the profits of each year in priority to the ordinary shares and ordinary stock of the company; but if in any year ending on the day prescribed in the Special Act, and if no day is prescribed, then on the thirty-first day of December, there are not profits available for the payment of the full amount of preferential dividend or interest for that year, no part of the deficiency shall be made good out of the profits of any subsequent year, or out of any other funds of the company.

Separate Accounts of Debenture Stock

33. Separate and distinct accounts shall be kept by the company showing how much money has been received for or on account of debenture stock, and how much money borrowed or owing on mortgage or bond, or which they have power so to borrow, has been paid off by debenture stock, or raised thereby, instead of being borrowed on mortgage or bond.

THE COMPANIES CLAUSES ACT, 1869

32 & 33 Vict. Ch. 48

Power to Issue Shares or Stock at a Discount

5. Section 21 of the Companies Clauses Act, 1863, shall, with respect to any company to which it is applicable under the provisions of this or any other Act, be read and have effect as if the following words—that is to say, ‘but so that not less than the full nominal amount of any share or portion of stock be payable or paid in respect thereof,’ had not been inserted in that section.

6. Any shares forming part of the capital (whether original or additional) authorised to be raised by any special Act of the company passed before the present session which have not been disposed of may be disposed of in manner provided by Part II of the Companies Clauses Act, 1863, as amended by this Act, and that part, as so amended, shall be deemed incorporated with such special Act accordingly.

7. Provided that any shares, the creation whereof has been authorised by the company, but which have not been issued before the passing of this Act, shall not be issued on any terms other than those whereon the same might have been issued if this Act had not been passed, unless and until the issue thereof on terms other than as aforesaid is after the passing of this Act authorised by the company in manner provided by Part II of the Companies Clauses Act, 1863.

8. Provided always that this Act shall not be construed to alter or extend the provisions of any Act relating to share capital in respect of which the amount of profits to be divided is limited to a fixed rate per centum upon the paid-up capital of the company.

ASSURANCE COMPANIES ACT, 1909

9 Edw. 7, Ch. 49

NOTE.—The following have been repealed by the Assurance Companies Act, 1946, and have therefore been omitted: Section 31, paragraphs (b), (c), (d), (f); Section 32, paragraphs (b), (c), (e); Section 34, paragraph (c).

Companies to which Act applies

1. This Act shall apply to all persons or bodies of persons, whether corporate or unincorporate, not being registered under the Acts relating to friendly societies or to trade unions (which persons and bodies of persons are hereinafter referred to as assurance companies), whether established before or after the commencement of this Act and whether established within or without the United Kingdom, who carry on within the United Kingdom assurance business of all or any of the following classes:

- (a) Life assurance business; that is to say, the issue of, or the undertaking of liability under, policies of assurance upon human life, or the granting of annuities upon human life;
- (b) Fire insurance business; that is to say, the issue of, or the undertaking of liability under, policies of insurance against loss by or incidental to fire;
- (c) Accident insurance business; that is to say, the issue of, or the undertaking of liability under, policies of insurance upon the happening of personal accidents, whether fatal or not, disease, or sickness, or any class of personal accidents, disease, or sickness;

- (d) Employers' liability insurance business; that is to say, the issue of, or the undertaking of liability under, policies insuring employers against liability to pay compensation or damages to workmen in their employment;
- (e) Bond investment business; that is to say, the business of issuing bonds or endowment certificates by which the company, in return for subscriptions payable at periodical intervals of two months or less, contract to pay the bondholder a sum at a future date, and not being life assurance business as hereinbefore defined;

subject as respects any class of assurance business to the special provisions of this Act relating to business of that class.

A company registered under the Companies Acts which transacts assurance business of any such class as aforesaid in any part of the world shall for the purposes of this provision be deemed to be a company transacting such business within the United Kingdom.

GENERAL

Deposit

2.—(1) Every assurance company shall deposit and keep deposited with the Paymaster-General for and on behalf of the Supreme Court the sum of twenty thousand pounds.

(2) The sum so deposited shall be invested by the Paymaster-General in such of the securities usually accepted by the Court for the investment of funds placed under its administration as the company may select, and the interest accruing due on any such securities shall be paid to the company.

(3) The deposit may be made by the subscribers of the memorandum of association of the company, or any of them, in the name of the proposed company, and, upon the incorporation of the company, shall be deemed to have been made by, and to be part of the assets of, the company, and the Registrar shall not issue a certificate of incorporation of the company until the deposit has been made.

(4) Where a company carries on, or intends to carry on, assurance business of more than one class, a separate sum of twenty thousand pounds shall be deposited and kept deposited under this section as respects each class of business, and the deposit made in respect of any class of business in respect of which a separate assurance fund is required to be kept shall be deemed to form part of that fund, and all interest accruing due on any such deposit or the securities in which it is for the time being invested shall be carried by the company to that fund.

(5) The Paymaster-General shall not accept a deposit except on a warrant of the Board of Trade.

(6) The Board of Trade may make rules with respect to applications for warrants, the payment of deposits, and the investment thereof or dealing therewith, the deposit of stocks or other securities in lieu of money, the payment of the interest or dividends from time to time accruing due on any securities in which deposits are for the time being invested, and the withdrawal and transfer of deposits, and the rules so made shall have effect as if they were enacted in this Act, and shall be laid before Parliament as soon as may be after they are made.

(7) This section shall apply to an assurance company registered or having its head office in Ireland, subject to the following modifications:

References to the Supreme Court shall be construed as references to the Supreme Court of Judicature in Ireland, and references to the Paymaster-General shall be construed as references to the Accountant-General of the last-mentioned Court.

Separation of Funds

3.—(1) In the case of an assurance company transacting other business besides that of assurance or transacting more than one class of assurance business, a separate account shall be kept of all receipts in respect of the assurance business or of each class of assurance business, and the receipts in respect of the assurance business, or, in the case of a company carrying on more than one class of assur-

ance business, of each class of business, shall be carried to and form a separate assurance fund with an appropriate name: Provided that nothing in this section shall require the investments of any such fund to be kept separate from the investments of any other fund.

(2) A fund of any particular class shall be as absolutely the security of the policy holders of that class as though it belonged to a company carrying on no other business than assurance business of that class, and shall not be liable for any contracts of the company for which it would not have been liable had the business of the company been only that of assurance of that class, and shall not be applied, directly or indirectly, for any purposes other than those of the class of business to which the fund is applicable.

Accounts and Balance Sheets

4. Every assurance company shall, at the expiration of each financial year of the company, prepare—

- (a) A Revenue account for the year in the form or forms set forth in the First Schedule to this Act and applicable to the class or classes of assurance business carried on by the company;
- (b) A profit and loss account in the form set forth in the Second Schedule to this Act, except where the company carries on assurance business of one class only and no other business;
- (c) A balance sheet in the form set forth in the Third Schedule to this Act.

Actuarial Report and Abstract

5.—(1) Every assurance company shall, once in every five years, or at such shorter intervals as may be prescribed by the instrument constituting the company, or by its regulations or bye-laws, cause an investigation to be made into its financial condition, including a valuation of its liabilities, by an actuary, and shall cause an abstract of the report of such actuary to be made in the form or forms set forth in the Fourth Schedule to this Act and applicable to the class or classes of assurance business carried on by the company.

(2) The foregoing provisions of this section shall also apply whenever at any other time an investigation into the financial condition of an assurance company is made with a view to the distribution of profits, or the results of which are made public.

Statement of Assurance Business

6. Every assurance company shall prepare a statement of its assurance business at the date to which the accounts of the company are made up for the purposes of any such investigation as aforesaid in the form or forms set forth in the Fifth Schedule to this Act and applicable to the class or classes of assurance business carried on by the company: Provided that, if the investigation is made annually by any company, the company may prepare such a statement at any time, so that it be made at least once in every five years.

Deposit of Accounts, &c., with Board of Trade

7.—(1) Every account, balance sheet, abstract, or statement hereinbefore required to be made shall be printed, and four copies thereof, one of which shall be signed by the chairman and two directors of the company and by the principal officer of the company and, if the company has a managing director, by the managing director, shall be deposited at the Board of Trade within six months after the close of the period to which the account, balance sheet, abstract, or statement relates: Provided that, if in any case it is made to appear to the Board of Trade that the circumstances are such that a longer period than six months should be allowed, the Board may extend that period by such period not exceeding three months as they think fit.

(2) The Board of Trade shall consider the accounts, balance sheets, abstracts, and statements so deposited, and, if any such account, balance sheet, abstract, or statement appears to the Board to be inaccurate or incomplete in any respect, the Board shall communicate with the company with a view to the correction of any such inaccuracies and the supply of deficiencies.

(3) There shall be deposited with every revenue account and balance sheet of a company any report on the affairs of the company submitted to the shareholders or policy holders of the company in respect of the financial year to which the account and balance sheet relates.

(4) Where an insurance company registered under the Companies Acts in any year deposits its accounts and balance sheet in accordance with the provisions of this section, the company may, at the same time, send to the Registrar a copy of such accounts and balance sheet; and, where such copy is so sent, it shall not be necessary for the company to send to the Registrar a statement in the form of a balance sheet as required by subsection (3) of Section 26 of the Companies (Consolidation) Act, 1908, and the copy of the accounts and balance sheet so sent shall be dealt with in all respects as if it were a statement sent in accordance with that subsection.

Right of Shareholders, &c., to Copies of Accounts, &c.

8. A printed copy of the last-deposited accounts, balance sheet, abstract, or statement, shall on the application of any shareholder or policy holder of the company be forwarded to him by the company by post or otherwise.

Audit of Accounts

9. Where the accounts of an insurance company are not subject to audit in accordance with the provisions of the Companies (Consolidation) Act, 1908, or the Companies Clauses Consolidation Act, 1845, relating to audit, the accounts of the company shall be audited annually in such manner as the Board of Trade may prescribe, and the regulations made for the purpose may apply to any such company the provisions of the Companies (Consolidation) Act, 1908, relating to audit, subject to such adaptations and modifications as may appear necessary or expedient.

List of Shareholders

10. Every assurance company which is not registered under the Companies Acts, or which has not incorporated in its deed of settlement Section 10 of the Companies Clauses Consolidation Act, 1845, shall keep a 'shareholders' address book', in accordance with the provisions of that section, and shall, on the application of any shareholder or policy holder of the company, furnish to him a copy of such book, on payment of a sum not exceeding sixpence for every hundred words required to be copied.

Deed of Settlement

11. Every assurance company which is not registered under the Companies Acts shall cause a sufficient number of copies of its deed of settlement or other instrument constituting the company to be printed, and shall, on the application of any shareholder or policy holder of the company, furnish to him a copy of such deed of settlement or other instrument on payment of a sum not exceeding one shilling.

Publication of Authorised, Subscribed, and Paid-up Capital

12. Where any notice, advertisement, or other official publication of an assurance company contains a statement of the amount of the authorised capital of the company, the publication shall also contain a statement of the amount of the capital which has been subscribed and the amount paid up.

Custody and Inspection of Documents deposited with Board of Trade

20. The Board of Trade may direct any documents deposited with them under this Act, or certified copies thereof, to be kept by the Registrar or by any other officer of the Board of Trade; and any such documents and copies shall be open to inspection, and copies thereof may be procured by any person on payment of such fees as the Board of Trade may direct.

Evidence of Documents

21.—(1) Every document deposited under this Act with the Board of Trade, and certified by the Registrar or by any person appointed in that behalf by the President of the Board of Trade to be a document so deposited, shall be deemed to be a document so deposited.

(2) Every document purporting to be certified by the Registrar, or by any person appointed in that behalf by the President of the Board of Trade, to be a copy of a document so deposited shall be deemed to be a copy of that document, and shall be received in evidence as if it were the original document, unless some variation between it and the original document be proved.

Alteration of Forms

22. The Board of Trade may, on the application or with the consent of an assurance company, alter the forms contained in the Schedules to this Act as respects that company, for the purpose of adapting them to the circumstances of that company.

Penalty for Non-compliance with Act

23. Any assurance company which makes default in complying with any of the requirements of this Act shall be liable to a penalty not exceeding one hundred pounds, or, in the case of a continuing default, to a penalty not exceeding fifty pounds for every day during which the default continues, and every director manager, or secretary, or other officer or agent of the company who is knowingly a party to the default shall be liable to a like penalty; and, if default continue for a period of three months after notice of default by the Board of Trade (which notice shall be published in one or more newspapers as the Board of Trade may, upon the application of one or more policy holders or shareholders, direct), the default shall be a ground on which the Court may order the winding-up of the company, in accordance with the Companies (Consolidation) Act, 1908.

Penalty for Falsifying Statements, &c.

24. If any account, balance sheet, abstract, statement or other document required by this Act is false in any particular to the knowledge of any person who signs it, that person shall be guilty of a misdemeanour, and shall be liable on conviction on indictment to fine and imprisonment, or on summary conviction to a fine not exceeding fifty pounds.

Recovery and Application of Penalties

25. Every penalty imposed by this Act shall be recovered and applied in the same manner as penalties imposed by the Companies (Consolidation) Act, 1908, are recoverable and applicable.

Service of Notices

26. Any notice which is by this Act required to be sent to any policy holder may be addressed and sent to the person to whom notices respecting such policy are usually sent, and any notice so addressed and sent shall be deemed and taken to be notice to the holder of such policy:

Provided that where any person claiming to be interested in a policy has given to the company notice in writing of his interest, any notice which is by this Act required to be sent to policy holders shall also be sent to such person at the address specified by him in his notice.

Accounts, &c., to be laid before Parliament

27. The Board of Trade shall lay annually before Parliament the accounts, balance sheets, abstracts, statements, and other documents under this Act, or purporting to be under this Act, deposited with them during the preceding year, except reports on the affairs of assurance companies submitted to the shareholders or policy holders thereof, and may append to such accounts, balance sheets, abstracts, statements, or other documents any note of the Board of Trade thereon, and any correspondence in relation thereto.

Savings

28.—(1) This Act shall not affect the National Debt Commissioners or the Postmaster-General, acting under the authorities vested in them respectively by the Government Annuities Acts, 1829 to 1888, and the Post Office Savings Bank Acts, 1861 to 1908.

(2) This Act shall not apply to a member of Lloyd's, or of any other association of underwriters approved by the Board of Trade, who carries on assurance business of any class, provided that he complies with the requirements set forth in the Eighth Schedule to this Act, and applicable to business of that class.

(3) Save as otherwise expressly provided by this Act, nothing in this Act shall apply to assurance business of any class other than one of the classes specified in Section 1 of this Act, and a policy shall not be deemed to be a policy of fire insurance by reason only that loss by fire is one of the various risks covered by the policy.

Interpretation

29. In this Act, unless the context otherwise requires—

The expression 'chairman' means the person for the time being presiding over the board of directors or other governing body of the assurance company;

The expression 'annuities on human life' does not include superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of persons engaged or who have been engaged in any particular profession, trade, or employment, or of the dependants of such persons;

The expression 'policy holder' means the person who for the time being is the legal holder of the policy for securing the contract with the assurance company;

The expression 'underwriter' includes any person named in a policy or other contract of insurance as liable to pay or contribute towards the payment of the sum secured by such policy or contract;

The expression 'financial year' means each period of twelve months at the end of which the balance of the accounts of the assurance company is struck, or, if no such balance is struck, then the calendar year;

The expression 'Court' means the High Court of Justice in England, except that in the case of an assurance company registered or having its head office in Ireland it means, in the provisions of this Act, the High Court of Justice in Ireland, and in the case of an assurance company registered, or having its head office in Scotland it means, in the provisions of this Act other than those relating to deposits, the Court of Session, in either division thereof;

The expression 'Companies Acts' includes the Companies (Consolidation) Act, 1908, and any enactment repealed by that Act;

The expression 'Registrar' means the Registrar of joint stock companies;

The expression 'actuary' means an actuary possessing such qualifications as may be prescribed by rules made by the Board of Trade;

The expression '*Gazette*' means the London, Edinburgh, or Dublin *Gazette*, as the case may be.

APPLICATION TO SPECIAL CLASSES OF BUSINESS

Application to Life Assurance Companies

30. Where a company carries on life assurance business, this Act shall apply with respect to that business, subject to the following modifications:

- (a) 'Policy on human life' shall mean any instrument by which the payment of money is assured on death (except death by accident only) or the happening of any contingency dependent on human life, or any instrument evidencing a contract which is subject to payment of premiums for a term dependent on human life;
- (b) Where the company grant annuities upon human life, 'policy' shall include the instrument evidencing the contract to pay such an annuity, and 'policy holder' includes annuitant;
- (c) The obligation to deposit and keep deposited the sum of twenty thousand pounds shall apply notwithstanding that the company has previously made and withdrawn its deposit, or been exempted from making any deposit under any enactment hereby repealed;
- (d) Where the company intends to amalgamate with or to transfer its life assurance business to another assurance company, the Court shall not sanction the amalgamation or transfer in any case in which it appears to the Court that the life policy holders representing one-tenth or more of the total amount assured in the company dissent from the amalgamation or transfer;

- (e) Nothing in this Act providing that the life assurance fund shall not be liable for any contracts for which it would not have been liable had the business of the company been only that of life assurance shall affect the liability of that fund, in the case of a company established before the ninth day of August, eighteen hundred and seventy, for contracts entered into by the company before that date;
- (f) In the case of a company carrying on life assurance business and established before the ninth day of August, eighteen hundred and seventy, by the terms of whose deed of settlement the whole of the profits of all the business carried on by the company are paid exclusively to the life policy holders, and on the face of whose life policies the liability of the life assurance fund in respect of the other business distinctly appears, such of the provisions of this Act as require the separation of funds and exempt the life assurance fund from liability for contracts to which it would not have been liable had the business of the company been only that of life assurance, shall not apply;
- (g) Any business carried on by an assurance company which under the provisions of any special Act relating to that company is to be treated as life assurance business shall continue to be so treated, and shall not be deemed to be other business or a separate class of assurance business within the meaning of this Act;
- (h) In the case of a mutual company whose profits are allocated to members wholly or mainly by annual abatements of premium, the abstract of the report of the actuary on the financial condition of the company, prepared in accordance with the Fourth Schedule to this Act, may, notwithstanding anything in Section 5 of this Act, be made and returned at intervals not exceeding five years, provided that, where such return is not made annually, it shall include particulars as to the rates of abatement of premiums applicable to different classes or series of assurances allowed in each year during the period which has elapsed since the previous return under the Fourth Schedule.

Application to Fire Insurance Companies

31. Where a company carries on fire insurance business, this Act shall apply with respect to that business, subject to the following modifications:

- (a) It shall not be necessary for the company to prepare any statement of its fire insurance business in accordance with the Fourth and Fifth Schedules to this Act;
- (e) So much of this Act as requires an assurance company transacting other business besides assurance business, or more than one class of assurance business, to keep separate funds into which all receipts in respect of the assurance business or of each class of assurance business are to be paid shall not apply as respects fire insurance business:

Application to Accident Insurance Companies

32. Where a company carries on accident insurance business, this Act shall apply with respect to that business, subject to the following modifications:

- (a) In lieu of the provisions of Sections 5 and 6 of this Act the following provisions shall be substituted:
'The company shall annually prepare a statement of its accident insurance business in the form set forth in the Fourth Schedule to this Act and applicable to accident insurance business, and the statement shall be printed, signed, and deposited at the Board of Trade in accordance with Section 7 of this Act.'
- (d) So much of this Act as requires an assurance company transacting other business besides assurance business, or more than one class of assurance business, to keep separate funds into which all receipts in respect of the assurance business or of each class of assurance business are to be paid shall not apply as respects accident insurance business;
- (f) The expression 'policy' includes any policy under which there is for the time being an existing liability already accrued, or under which a liability may accrue;

- (g) Where a sum is due, or a weekly or other periodical payment is payable, under any policy, the expression 'policy holder' includes the person to whom the sum is due or the weekly or other periodical payment payable.

Application to Bond Investment Companies

34. Where a company carries on bond investment business, this Act shall apply with respect to that business, subject to the following modifications:

- (a) The expression 'policy' includes any bond, certificate, receipt, or other instrument evidencing the contract with the company, and the expression 'policy holder' means the person who for the time being is the legal holder of such instrument;
- (b) Such of the provisions of this Act as relate to deposits shall not apply with respect to the bond investment business carried on by the company, if the company has commenced to carry on that business in the United Kingdom before the passing of this Act;
- (d) The first statement of the bond investment business of the company shall be deposited at the Board of Trade on or before the thirtieth day of June, nineteen hundred and eleven;
- (e) The company shall not give the holder of any policy issued after the passing of this Act any advantage dependent on lot or chance, but this provision shall not be construed as in anywise prejudicing any question as to the application to any such transaction, whether in respect of a policy issued before or after the passing of this Act, of the law relating to lotteries.

Power of Board of Trade to Exempt Unregistered Trade Unions and Friendly Societies

35. The Board of Trade may, on the application of any unregistered trade union originally established more than twenty years before the commencement of this Act, extend to the trade union the exemption conferred by this Act on registered trade unions, and may on the application of an unregistered friendly society extend to the society the exemption conferred by this Act on registered friendly societies if it appears to the Board, after consulting the Chief Registrar of Friendly Societies, that the society is one to which it is inexpedient that the provisions of this Act should apply.

Provisions as to Collecting Societies and Industrial Assurance Companies

36.—(1) Amongst the purposes for which collecting societies and industrial assurance companies may issue policies of assurance there shall be included insuring money to be paid for the funeral expenses of a parent, grandparent, grandchild, brother, or sister.

(2) No policy effected before the passing of this Act with a collecting society or industrial assurance company shall be deemed to be void by reason only that the person effecting the policy had not, at the time the policy was effected, an insurable interest in the life of the person assured, or that the name of the person interested, or for whose benefit or on whose account the policy was effected, was not inserted in the policy, or that the insurance was not one authorised by the Acts relating to friendly societies, if the policy was effected by or on account of a person who had at the time a bona fide expectation that he would incur expenses in connection with the death or funeral of the assured, and if the sum assured is not unreasonable for the purpose of covering those expenses, and any such policy shall enure for the benefit of the person for whose benefit it was effected or his assigns.

(3) Any collecting society or industrial insurance company which, after the passing of this Act, issues policies of insurance which are not within the legal powers of such society or company shall be held to have made default in complying with the requirements of this Act; and the provisions of this Act with respect to such default shall apply to collecting societies, industrial insurance companies, and their officers, in like manner as they apply to assurance companies and their officers.

(4) Without prejudice to the powers conferred by Section 71 of the Friendly Societies Act, 1896, the committee of management or other governing body of a collecting society having more than one hundred thousand members may petition

the Court to make an order for the conversion of the society into a mutual company under the Companies (Consolidation) Act, 1908, and the Court may make such an order if, after hearing the committee of management, or other governing body, and other persons whom the Court considers entitled to be heard on the petition, the Court is satisfied, on a poll being taken, that 55 per cent. at least of the members of the society over sixteen years of age agree to the conversion; and the Court may give such directions as it thinks fit for settling a proper memorandum and articles of association of the company; but, before any such petition is presented to the Court, notice of intention to present the petition shall be published in the *Gazette*, and in such newspapers as the Court may direct.

When a collecting society converts itself into a company in accordance with the provisions of this subsection, subsection (3) of Section 71 of the Friendly Societies Act, 1896, shall apply in like manner as if the conversion were effected under that section.

(5) In this section the expressions 'collecting society' and 'industrial assurance company' have the same meanings as in the Collecting Societies and Industrial Assurance Companies Act, 1896.

NOTE.—The forms prescribed in the First, Second and Third Schedules of the Assurance Companies Act, 1909, which are reproduced in the following pages, will require modification in consequence of the requirements of the Companies Act, 1948, in regard to company accounts and balance sheets.

By paragraph 1 of the Sixteenth Schedule to the Companies Act, 1948, the Assurance Companies Acts, 1909 to 1946, are to have effect as if—

- (b) the powers conferred on the Board of Trade and the Industrial Assurance Commissioner respectively by virtue of subsection (3) of Section 7 of the Assurance Companies Act, 1946, to make regulations providing for the modification, in consequence of the passing of that Act, of the forms set out in the Schedule to the Assurance Companies Act, 1909, extended to the modification, having regard to the provisions of the Eighth Schedule to this Act, of any form set out in the Schedules to either of those Acts.

At the time of writing, no regulations have been made for the amendment of these forms.

(B) *Form applicable to Fire Insurance Business*
 Revenue Account of the for the Year ending 19..... in respect of Fire Insurance business

£ s d			£ s d			£ s d			£ s d		
Amount of Fire Insurance Fund at the beginning of the year:						Claims under Policies paid and outstanding			.. ..	
Reserve for unexpired risks						Commission .. ..			.. ..
Additional Reserve (if any)						Expenses of Management .. ..			.. ..
						Contributions to Fire Brigades .. ..			.. ..
Premiums .. ..			.. ..			Other payments (accounts to be specified)			.. ..	
Interest, Dividends and Rents			£ s d			Amount of Fire Insurance Fund at the end of the year as per Third Schedule:			£ s d		
Less Income Tax thereon £						Reserve for unexpired risks being per cent. of Premium income for the year .. ..			.. ..
Other receipts (accounts to be specified) .. ..			.. ..			Additional Reserve (if any) .. ..			.. ..

Notes.—

1. Items in this Account to be the net amounts after deduction of the amounts paid and received in respect of re-insurances of the Company's risks.
2. If any sum has been deducted from the Expenses of Management Account, and taken credit for in the Balance Sheet as an asset, the sum so deducted to be separately shown in the above account.

(C) Form applicable to Accident Insurance Business

Revenue Account of the.....for the Year ending.....19.....in respect of Accident Insurance business

£ s d			£ s d			£ s d		
Amount of Accident Insurance Fund at the beginning of the year:						Payments under Policies, including Medical and Legal Expenses in connection therewith		
Reserve for unexpired risks						Commission		
Total estimated liability in respect of outstanding claims						Expenses of Management		
Additional Reserve (if any)						Other payments (accounts to be specified)		
						£ s d		
						Amount of Accident Insurance Fund at the end of the year as per Third Schedule:		
						Reserve for unexpired risks, being per cent. of Premium Income for the year		
Premiums—			£ s d			Total estimated Liability in respect of outstanding claims as per Fourth Schedule (C)		
Interest, Dividends and Rents						Additional Reserve (if any)		
Less Income Tax thereon								
Other receipts (accounts to be specified)								

(E) Form applicable to Bond Investment Business

Revenue Account of the.....for the Year ending.....19..... in respect of Bond Investment
and Endowment Certificate Business

£ s d		£ s d		£ s d	
Amount of Bond Investment and Endowment Certificate Fund at the beginning of the year		Claims under Bonds and Certificates, paid and outstanding	
Additional Reserve (if any)		Commission	
Premiums		Expenses of Management	
Interest, Dividends and Rents		Other payments (accounts to be specified)	
Less Income Tax thereon		Amount of Bond Investment and Endowment Certificate Fund at the end of the year as per Third Schedule	
Other receipts (accounts to be specified)		Additional Reserve (if any)	
				£	

Notes—

1. Items in this account to be the net amounts after deduction of the amounts paid and received in respect of re-insurances of the Company's risks.
2. If any sum has been deducted from the Expenses of Management Account, and taken credit for in the Balance Sheet as an asset, the sum so deducted to be separately shown in the above Account.

Section 4

SECOND SCHEDULE

PROFIT AND LOSS ACCOUNT of the.....for the Year ending.....19.....

				£	s	d
				£		
Balance of last year's account ..	..	..	..	Dividends and bonuses to shareholders ..	..	..
Interest and Dividends not carried to other accounts			£	Expenses not charged to other accounts ..	..	..
Less Income Tax thereon ..	..	..	..	Loss realised (accounts to be specified) ..	..	..
Profit realised (accounts to be specified) ..	..	..	..	Other payments (accounts to be specified) ..	..	..
Other Receipts (accounts to be specified) ..	..	..	..	Balance as per Third Schedule ..	..	..

Liabilities		Assets
Shareholders' Capital paid up (if any)		Mortgages on Property within the United Kingdom
Life Assurance Funds.*		out of the United Kingdom
Ordinary Branch		Loans on "Parochial and other Public Rates
Industrial Branch		" Life Interests
Annuity Fund*		" Reversions
Fire Insurance Fund		" Stocks and Shares
Accident Insurance Fund		" Company's Policies within their surrender values
Employers' Liability Insurance Fund		" Personal security
Bond Investment and Endowment Certificate Fund		Investments:
Marine Insurance Fund		Deposit with the High Court (securities to be specified)
Sinking Fund and Capital Redemption Fund		British Government Securities
Profit and Loss Account		Municipal and County Securities, United Kingdom
Other Funds (if any) to be specified		Indian and Colonial Government Securities
Claims admitted or intimated but not paid†		" Provincial Securities
Life Assurance		" Municipal Securities
Fire Insurance		" Government Securities
Bond Investment		" Municipal Securities
Annuities due and unpaid†		Railway and other Debentures and Debenture Stocks—
Other sums owing by the company† (to be stated separately under each class of business):		Home and Foreign
		Railway and other preference and guaranteed stocks
		" ordinary stocks
		Rent Charges
		Freehold Ground Rents
		Leasehold Ground Rents
		House Property
		Life Interests
		Reversions
		Agents' Balances
		Outstanding Premiums†
		" Interest, Dividends and Rents†
		Interest accrued but not payable†
		Bills Receivable
		Cash—
		On Deposit
		In hand and on current account
		Other assets (to be specified)
		£

* Life companies having separate annuity fund to show amount thereof separately.
† These items are or have been included in the corresponding items in the First Schedule.

Notes.—

1. When part of the assets of the company are specifically deposited, under local laws, in various places out of the United Kingdom, as security to holder of policies there issued, each such place and the amount compulsorily lodged therein must be specified in respect of each class of business, except that, in the case of fire, accident, or employers' liability insurance business, it shall be sufficient to state the fact that a part of the assets has been so deposited.
2. A Balance Sheet in the above form must be rendered in respect of each separate fund for which separate investments are made.
3. The Balance Sheet must state how the values of the Stock Exchange securities are arrived at, and a certificate must be appended, signed by the same persons as sign the Balance Sheet, to the effect that in their belief the assets set forth in the Balance Sheet are in the aggregate fully of the value stated therein, less any investment reserve fund taken into account. In the case of a company transacting life assurance business or bond investment business, this certificate is to be given on the occasions only when a statement respecting valuation under the Fourth Schedule is made.
4. In the case of a company required to keep separate funds under Section 3 of this Act, a certificate must be appended, signed by the same persons as signed the Balance Sheet and by the auditor, to the effect that no part of any such fund has been applied, directly or indirectly, for any purpose other than the class of business to which it is applicable.

	£	s	d	£	s	d
Shareholders' Capital paid up (if any)	..					
Life Assurance Funds*	..					
Ordinary Branch	..					
Industrial Branch	..					
Annuity Fund*	..					
Fire Insurance Fund	..					
Accident Insurance Fund	..					
Employers' Liability Insurance Fund	..					
Bond Investment and Endowment Certificate Fund	..					
Marine Insurance Fund	..					
Sinking Fund and Capital Redemption Fund	..					
Profit and Loss Account	..					
Other Funds (if any) to be specified	..					
Claims admitted or intimated but not paid†	..					
Life Assurance	..					
Fire Insurance	..					
Bond Investment	..					
Annuities due and unpaid	..					
Other sums owing by the company† (to be stated separately under each class of business):	..					

	£	s	d	£	s	d
Mortgages on Property within the United Kingdom	..					
Loans on Parochial and other Public Rates	..					
" Life Interests	..					
" Reversions	..					
" Stocks and Shares	..					
" Company's Policies within their surrender values	..					
" Personal security	..					
Investments:	..					
Deposit with the High Court (securities to be specified)	..					
British Government Securities	..					
Municipal and County Securities, United Kingdom	..					
Indian and Colonial Government Securities	..					
" Provincial Securities	..					
" Municipal Securities	..					
Foreign Government Securities	..					
" Provincial Securities	..					
" Municipal Securities	..					
Railway and other Debentures and Debenture Stocks—	..					
Home and Foreign	..					
Railway and other preference and guaranteed stocks	..					
" ordinary stocks	..					
" Rent Charges	..					
Freehold Ground Rents	..					
Leasehold Ground Rents	..					
House Property	..					
Life Interests	..					
Reversions	..					
Agents' Balances	..					
Outstanding Premiums†	..					
" Interest, Dividends and Rents†	..					
Interest accrued but not payable†	..					
Bills Receivable	..					
Cash—	..					
On Deposit	..					
In hand and on current account	..					
Other assets (to be specified)	..					

* Life companies having separate annuity fund to show amount thereof separately.
† These items are or have been included in the corresponding items in the First Schedule.

Notes.—

1. When part of the assets of the company are specifically deposited under local laws, in various places out of the United Kingdom, as security to holder of policies issued, each such place and the amount compulsorily lodged therein must be specified in respect of each class of business, except that, in the case of fire, accident, or employers' liability insurance business, it shall be sufficient to state the fact that a part of the assets has been so deposited.

2. A Balance Sheet in the above form must be rendered in respect of each separate fund for which separate investments are made.

1. Balance sheet in the above form must be rendered in respect of each separate investment, as made, signed by the same persons as the Balance Sheet must state how the values of the Stock Exchange Securities are arrived at, and a certificate fully of the value stated therein, less any investment in the Balance Sheet, that is to say, that use of a company transacting life assurance business or bond investment business, this certificate is to be given on the occasions when a fund taken into account for valuation under the Fourth Schedule is made.

4. In the case of a company required to keep separate funds under Section 3 of this Act, a certificate must be appended, signed by the same persons as signed the Balance Sheet and by the auditor, to the effect that no part of any fund has been applied, directly or indirectly, for any purpose other than the class of business to which it is applicable.

FOURTH SCHEDULE

N.B.—Where sinking fund or capital redemption insurance business is carried on, a separate statement signed by the actuary must be furnished, showing the total number of policies valued, the total sums assured, and the total office yearly premiums, and also showing the total net liability in respect of such business and the basis on which such liability is calculated.

(A)—*Form applicable to Life Assurance Business*

STATEMENT respecting the Valuation of the Liabilities under Life Policies and Annuities of the _____, to be made and signed by the Actuary.

(The answer should be numbered to accord with the numbers of the corresponding questions.)

1. The date up to which the valuation is made.
2. The general principles adopted in the valuation, and the method followed in the valuation of particular classes of assurances, including a statement of the method by which the net premiums have been arrived at, and whether these principles were determined by the instrument constituting the company, or by its regulations or bye-laws or how otherwise; together with a statement of the manner in which policies on under-average lives are dealt with.
3. The table or tables of mortality used in the valuation. In cases where the tables employed are not published, specimen policy values are to be given, at the rate of interest employed in the valuation, in respect of whole-life assurance policies effected at the respective ages of 20, 30, 40 and 50, and having been respectively in force for five years, ten years, and upwards at intervals of five years respectively; with similar specimen policy values in respect of endowment assurance policies according to age at entry, original term of policy, and duration.
4. The rate or rates of interest assumed in the calculations.
5. The actual proportion of the annual premium income, if any, reserved as a provision for future expenses and profits, separately specified in respect of assurances with immediate profits, with deferred profits and without profits. (If none, state how this provision is made.)
6. The consolidated revenue account since the last valuation, or, in case of a company which has made no valuation, since the commencement of the business. (This return should be made in the form annexed. No return under this heading will be required where a statement under this schedule is deposited annually.)
7. The liabilities of the company under life policies and annuities at the date of the valuation, showing the number of policies, the amount assured, and the amount of premiums payable annually under each class of policies, both with and without participation in profits; and also the net liabilities and assets of the company, with the amount of surplus or deficiency. (These returns to be made in the forms annexed.)
8. The principles upon which the distribution of profits among the shareholders and policy holders is made, and whether these principles were determined by the instrument constituting the company or by its regulations or bye-laws or how otherwise, and the number of years' premiums to be paid before a bonus (a) is allotted, and (b) vests.
9. The results of the valuation, showing—
 - (1) The total amount of profit made by the company, allocated as follows:
 - (a) Among the policy holders with immediate participation, and the number and amount of the policies which participated;
 - (b) Among policy holders with deferred participation, and the number and amount of the policies which participated;
 - (c) Among the shareholders;
 - (d) To reserve funds, or other accounts;

(e) Carried forward unappropriated.

(2) Specimens of bonuses allotted to whole-life assurance policies for £100 effected at the respective ages of 20, 30, 40, and 50, and having been respectively in force for five years, ten years, and upwards at intervals of five years respectively, together with the amounts apportioned under the various modes in which the bonus might be received; with similar specimen bonuses and particulars in respect of endowment assurance policies, according to age at entry, original term of policy, and duration.

NOTE.—Separate statements to be furnished throughout in respect of ordinary and industrial business respectively, the basis of the division being stated.

(FORM referred to under Heading No. 6 in Fourth Schedule (A))

CONSOLIDATED REVENUE ACCOUNT of the.....for.....years, commencing.....
and ending.....

		£	s	d			£	s	d
Amount of Life Assurance Fund at the beginning of the period ..					Claims under policies paid and outstanding				
Premiums	By death ..	..	..	..	..
Consideration for annuities granted	By maturity ..	..	..	..	..
Interest, dividends and rents	Surrenders ..	..	..	..	..
Less Income-tax thereon	Annuities ..	..	..	..	..
Other receipts (accounts to be specified):					Bonuses in cash ..	..	..	..	..
					" reduction of premiums ..	..	..	..	..
					Commission ..	..	..	..	..
					Expenses of management ..	..	..	..	..
					Other payments (accounts to be specified) ..	..	..	..	..
					Amount of Life Assurance Fund at the end of the period as per Third Schedule ..	..	..	..	..
							£		

Note.—If any sum has been deducted from the Expenses of Management Account, and taken credit for in the Balance Sheet as an asset, the sum so deducted to be separately shown in the above statement.

(Form referred to under Heading No. 7 in Fourth Schedule (A))
SUMMARY AND VALUATION of the Policies of the.....as at.....19.....

Description of Transactions	Particulars of the Policies for Valuation					VALUATION		
						Value by the	Table, Interest	per cent.
	Number of Policies	Sums assured and Bonuses	Office Yearly Premiums	Net Yearly Premiums	Sums assured and Bonuses	Office Yearly Premiums	Net Yearly Premiums	Net Liability
I. With immediate participation in profits:								
For whole term of life								
Other classes (to be specified) ..								
Extra premiums payable								
II. With deferred participation in profits:								
For whole term of life								
Other classes (to be specified) ..								
Extra premiums payable								
Total assurances with profits ..								
III. Without participation in profits:								
For whole term of life								
Other classes (to be specified) ..								
Extra premiums payable								
Total assurances without profits								
Total assurances								
Deduct re-assurances (to be specified according to class in a separate statement) ..								
Net amounts of assurances								
Adjustments, if any (to be separately specified)								
ANNUITIES ON LIVES								
Immediate								
Other classes (to be specified) ..								
Total of the results								

Notes.—
 1. The term 'extra premium' in this Act shall be taken to mean the charge for any risk not provided for in the minimum contract premium. If policies are issued, in or for any country at rate of premium deduced from tables other than the European mortality tables adopted by the company, separate schedules similar in form to the above must be furnished.
 2. Separate returns and valuation results must be furnished in respect of classes of policies valued by different tables of mortality, or at different rates of interest, also for business at other than European rates.
 3. In cases also where separate valuations of any portion of the business are required under local laws in places outside the United Kingdom, a summary statement must be furnished in respect of the business so valued in each such place, showing the total number of policies, the total sums assured and bonuses, the total office yearly premiums, and the total net liability and basis as to the mortality and interest adopted in each such place, with a statement as to such bases respectively.

(Form referred to under Heading No. 7 in Fourth Schedule (A))

VALUATION BALANCE SHEET OF.....as at.....19.....

<i>Dr.</i>	£ s d	<i>Cr.</i>	£ s d
To Net Liability under Life Assurance and Annuity transactions (as per summary statement provided in Fourth Schedule (A)) ..		By Life Assurance and Annuity Funds (as per Balance Sheet under Schedule 3)	
" Surplus, if any		" Deficiency, if any	

(C)—*Form applicable to Accident Insurance Business*

STATEMENT of the Estimated Liability in respect of Outstanding Claims arising in the year of Account, and in the preceding year or years; computed as at the end of the year in which the claims arose, and as at the end of the year of Account; with particulars as to the number and amount of the claims actually paid in the intervening period.

I.—Claims arising during the year of account ending 19 .

(a) Particulars as to claims arising, and settled, during the year of account:

Class of Claim (1)	No. of Claims (2)	Total amount paid	
		By Sums Insured (3)	By Weekly Allowance (4)
(i) Fatal claims			
(ii) Non-fatal claims			
Totals			

(b) Particulars as to claims arising during and outstanding at the end of the year of account:

Class of Claim (1)	No. of Claims (2)	Amount paid during Year of Account (3)	Estimated Liability (4)
(i) Fatal claims			
(ii) Non-fatal claims, involving payment of sums insured			
(iii) Non-fatal claims, involving payment of temporary weekly allowances:			
With maximum duration, not exceeding 26 weeks			
With maximum duration exceeding 26 weeks, but not exceeding 52 weeks ..			
And so on, at intervals of 26 weeks, up to the longest period over which temporary weekly allowances are granted			
(iv) Non-fatal claims, involving payment of yearly allowances during permanent total disablement			
Totals			

II.—Outstanding claims which arose during the *first year* preceding the year of account ending 19 .

Particulars of Claims (1)	Estimated Liability in respect of Claims outstanding as at the above date (2)		Claims paid during the Period of One Year between the above date and the end of year of Account				Estimated Liability in respect of Claims outstanding as at the end of year of Account (5)		Totals of Columns (3), (4) and (5) (6)	
			Terminated within such Period (3)		Not terminated within such Period (4)					
	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount
		£		£		£		£		£
(i) Fatal claims										
(ii) Non-fatal claims, involving payment of sums insured										
(iii) Non-fatal claims, involving payment of temporary weekly allowances:										
With maximum duration not exceeding 26 weeks										
With maximum duration exceeding 26 weeks, but not exceeding 52 weeks										
And so on, at intervals of 26 weeks, up to the longest period over which temporary weekly allowances are granted.										
(iv) Non-fatal claims, involving payment of yearly allowances during permanent total disablement . .										
Total										

Note.—If temporary weekly allowances are granted by the company for periods exceeding 52 weeks, particulars are to be furnished, in a form or forms similar to II above, showing, in respect of claims involving such extended allowances, the estimated liability as at the end of the year in which such claims arose, and as at the end of the year of account; and the number and amount of such actual claims paid during the intervening period of two (or more) years; distinguishing claims terminated, and not terminated, within such period.

III.—Summary of estimated liability, in respect of claims outstanding as at the end of the year of account—

As per column (4) of Statement I (b)	..	..	..	£
" " (5) " II	..	..	..
" " (5) of further schedules in the form of				

Statement II (if required).

In respect of yearly allowances during permanent total disablement, outstanding at the end of the year of account, but not included in the above statements ..	}	£

Total estimated liability, in respect of outstanding claims as at the end of the year of account, as per First Schedule (C)	}	£

(E)—Form applicable to Bond Investment Business

STATEMENT respecting the Valuation of the Liability under Bonds and Endowment Certificates of the to be made and signed by the Actuary.

(The answers should be numbered to accord with the numbers of the corresponding questions.)

1. The date up to which the valuation is made.

2. The principles adopted in the valuation of the liabilities under bond investment policies and endowment certificates, and whether these principles were determined by the instrument constituting the company, or by its regulations or bye-laws, or how otherwise.

3. The rate or rates of interest assumed in the calculations.

4. The actual proportion of the annual income from contributions, if any, reserved as a provision for future expenses and profits. (If none, state how this provision is made.)

5. The consolidated revenue account since the last valuation, or, in the case of a company which has made no valuation, since the commencement of the business. (This return should be made in the form annexed. No return under this heading will be required where the valuation is made annually.)

6. The liabilities of the company under bond investment policies and endowment certificates at the date of the valuation, showing the number of policies or certificates, the amounts assured, the amount of contribution payable annually, and the provision for future expenses and profits; also the net liabilities and assets of the company, with the amount of surplus or deficiency. (These returns should be made in the forms annexed.)

7. The principles upon which the distribution of profits among the bond and certificate holders and shareholders is made, and whether those principles are determined by the instrument constituting the company, or by its regulations or bye-laws, or how otherwise, and the time during which a bond investment policy or endowment certificate must be in force to entitle it to share in the profits.

8. The results of the valuation, showing—

(1) The total amount of profit made by the company, allocated as follows:

(a) among participating bond or certificate holders, with the number so participating and the total amount of their bonds or certificates;

(b) among the shareholders;

(c) to reserve funds, or other accounts;

(d) carried forward unappropriated.

(2) Specimens of profit allotted to policies or certificates for £100 effected for different periods, and having been in force for different durations.

Q

Description of Transaction	Particulars of the Policies or Certificates for Valuation		Valuation (Interest at per cent.)				
	No. of Policies	Sums Assured and Bonuses (if any)	Full Yearly Premiums	Value of sums Assured and Bonuses (if any)	Value of Full Yearly Premiums	Provisions for future Expenses and Profits	Net Liability
With participation in profits					
Without participation in profits					
Totals					
Deduct re-assurances (to be specified according to class)					
Net Totals					
Adjustments (if any)					
Totals of the results					

VALUATION BALANCE SHEET of the.....as at.....19.....

Dr.	£
To Net Liability under Bond Investment and Endowment Certificate transactions (as per summary statement provided in Fourth Schedule (E))	
" Surplus (if any)	..
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FIFTH SCHEDULE

N.B.—Where sinking fund or capital redemption business is carried on, a separate statement, signed by the actuary, must be furnished showing the total sums assured maturing in each calendar year and the corresponding office premiums.

(A)—*Form applicable to Life Assurance Business*

STATEMENT of the Life Assurance and Annuity Business of the
on the 19 , to be signed by the Actuary.

(The answers should be numbered to accord with the numbers of the corresponding questions. Statements of re-assurances corresponding to the statements in respect of assurances are to be given throughout.) Separate statements are to be furnished in the replies to all the headings under this Schedule for business at other than European rates. Separate statements are to be also furnished throughout in respect of ordinary and industrial business respectively.

1. The published table or tables of premiums for assurances for the whole term of life and for endowment assurances which are in use at the date above mentioned.

2. The total amount assured on lives for the whole term of life which are in existence at the date above mentioned, distinguishing the portions assured with immediate profits, with deferred profits, and without profits, stating separately the total reversionary bonuses and specifying the sums assured for each year of life from the youngest to the oldest ages, the basis of division as to immediate and deferred profits being stated.

3. The amount of premiums receivable annually for each year of life, after deducting the abatements made by the application of bonuses, in respect of the respective assurances mentioned under Heading No. 2, distinguishing ordinary from extra premiums. A separate statement is to be given of premiums payable for a limited number of years, classified according to the number of years' payments remaining to be made.

4. The total amount assured under endowment assurances, specifying sums assured and office premiums separately in respect of each year in which such assurances will mature for payment. The reversionary bonuses must also be separately specified, and the sums assured with immediate profits, with deferred profits, and without profits, separately returned.

5. The total amount assured under classes of assurance business, other than assurance dealt with under questions 2 and 4, distinguishing the sums assured under each class, and stating separately the amount assured with immediate profits, with deferred profits, and without profits, and the total amount of reversionary bonuses.

6. The amount of premiums receivable annually in respect of each such special class of assurances mentioned under Heading No. 5, distinguishing ordinary from extra premiums.

7. The total amount of premiums which has been received from the commencement upon pure endowment policies which are in force at the date above mentioned.

8. The total amount of immediate annuities on lives, distinguishing the amounts for each year of life, and distinguishing male and female lives.

9. The amount of all annuities on lives other than those specified under Heading No. 8, distinguishing the amount of annuities payable under each class, and the amount of premiums annually receivable.

10. The average rate of interest yielded by the assets, whether invested or uninvested, constituting the life assurance fund of the company calculated upon the mean fund of each year during the period since the last investigation, without deduction of income-tax.

It must be stated whether or not the mean fund upon which the average rate of interest is calculated includes reversionary investments.

11. A table of minimum values, if any, allowed for the surrender of policies for the whole term of life and for endowments and endowment assurances, or a statement of the method pursued in calculating such surrender values, with instances of the application of such method to policies of different standing and taken out at various interval ages from the youngest to the oldest. In the case of industrial policies, where free or paid-up policies are granted in lieu of surrender values, the conditions under which such policies are granted must be stated, with specimens as prescribed for surrender values.

(E)—*Form applicable to Bond Investment Business*

STATEMENT of the Bond Investment Business of the _____ on the
19 ____ . (To be signed by the Actuary.)

(The answers should be numbered to accord with the numbers of the corresponding questions. Statements of re-insurances, corresponding to the statements in respect of insurances, are throughout to be given.)

1. The published table or tables of rates of contribution for bond investment policies and endowment certificates which are in use at the date above-mentioned; with full particulars as to the terms and conditions on which advances are made under such policies or certificates, whether on security of house property or land, or otherwise.

2. The total amounts assured under policies or certificates which are in existence at the date above mentioned, distinguishing the portions insured with and without profits, stating separately the total additions by way of bonus, and specifying such sums insured and bonuses respectively according to the number of complete years unexpired at such date.

3. The amount of premiums receivable annually, in respect of the respective insurances mentioned under Heading No. 2, separately specified according to the number of complete years unexpired at the date above mentioned.

4. The total amount of premiums which have been received from the commencement upon all policies or certificates mentioned under Headings Nos. 2 and 3, separately specified according to the number of complete years unexpired at the date above mentioned.

5. The average rate of interest realised by the assets, whether invested or uninvested, constituting the bond investment and endowment certificate fund of the company, calculated upon the mean fund of each year during the period since the last investigation, without deduction of income-tax.

6. Full particulars as to the terms and conditions upon which surrenders of policies and certificates are granted, with specimens of the values allowed in respect of different durations, and different unexpired terms at the date of surrender.

7. Full particulars as to the terms and conditions upon which allowances are made on the death of a policy or certificate holder, with specimen values as required under Heading No. 6.

8. Full particulars as to the terms and conditions upon which transfers of the interest in a policy or certificate are granted, whether on the death of the policy or certificate holder, or during his lifetime.

9. Full particulars as to the terms and conditions upon which redemption of advances is granted, with specimens of redemption values in respect of bonds or certificates of different durations, and having different unexpired terms, at the date of redemption.

10. A tabular statement in respect of policies or certificates lapsed during the period since the last investigation, showing the number, the amount insured, the yearly premiums, and the total premiums received from the commencement; classified according to the year in which such policies or certificates were effected, and lapsed, respectively; with a similar tabular statement in respect of policies or certificates surrendered during the period: Provided that policies or certificates which have lapsed and been revived shall not be entered as lapses.

11. A statement of the total number of advances made under policies or certificates to the holders thereof, whether on the security of house property or land or otherwise, and the total amount of such advances outstanding at the date above mentioned, distinguishing the advances on first mortgage and those on second or subsequent mortgage.

SIXTH SCHEDULE

RULES FOR VALUING POLICIES AND LIABILITIES

(A)—AS RESPECTS LIFE POLICIES AND ANNUITIES

Rule for Valuing an Annuity

An annuity shall be valued according to the tables used by the company which granted such annuity at the time of granting the same, and, where such tables cannot be ascertained or adopted to the satisfaction of the Court, then according to such rate of interest and table of mortality as the Court may direct.

Rule for Valuing a Policy

The value of the policy is to be the difference between the present value of the reversion in the sum assured according to the contingency upon which it is payable, including any bonus or addition thereto made before the commencement of the winding-up, and the present value of the future annual premiums.

In calculating such present values interest is to be assumed at such rate, and the rate of mortality according to such tables, as the Court may direct.

The premium to be calculated is to be such premium as according to the said rate of interest and rate of mortality is sufficient to provide for the risk incurred by the office in issuing the policy, exclusive of any addition thereto for office expenses and other charges.

(B) AS RESPECTS FIRE POLICIES

Rule for Valuing a Policy

The value of a current policy shall be such portion of the last premium paid as is proportionate to the unexpired portion of the period in respect of which the premium was paid.

(C) AS RESPECTS ACCIDENT POLICIES

Rule for Valuing a Periodical Payment

The present value of a periodical payment shall, in the case of total permanent incapacity, be such an amount as would, if invested in the purchase of a life annuity from the National Debt Commissioners through the Post Office Savings Bank, purchase an annuity equal to seventy-five per centum of the annual value of the periodical payment, and, in any other case, shall be such proportion of such amount as may, under the circumstances of the case, be proper.

Rule for Valuing a Policy

The value of a current policy shall be such portion of the last premium paid as is proportionate to the unexpired portion of the period in respect of which the premium was paid.

(E) AS RESPECTS BONDS OR CERTIFICATES

Rule for Valuing a Policy or Certificate

The value of a policy or certificate is to be the difference between the present value of the sum assured according to the date at which it is payable, including any bonus or addition thereto made before the commencement of the winding-up, and the present value of the future annual premiums.

In calculating such present values, interest is to be assumed at such rate as the Court may direct.

The premium to be calculated is to be such premium as, according to the said rate of interest, is sufficient to provide for the sum assured by the policy or certificate, exclusive of any addition thereto for office expenses and other charges.

(Note.—See also Part II of the First Schedule to the Assurance Companies Act, 1946.)

SEVENTH SCHEDULE

Where an assurance company is being wound up by the Court or subject to the supervision of the Court, the liquidator, in the case of all persons appearing by the books of the company to be entitled to or interested in policies granted by such company, is to ascertain the value of the liability of the company to each such person, and give notice of such value to such persons in such manner as the Court may direct, and any person to whom notice is so given shall be bound by the value so ascertained unless he gives notice of his intention to dispute such value in manner and within a time to be prescribed by a rule or order of the Court.

EIGHTH SCHEDULE

(Note.—See Part II of the Second Schedule to the Assurance Companies Act, 1946.)

ASSURANCE COMPANIES ACT, 1946

9 & 10 Geo. 6, Ch. 28

1.—(1) Subsection (1) of Section 20 of the Air Navigation Act, 1936 (which defines aircraft insurance business and includes it among the classes of business to which the principal Act applies), shall not come into force with the other provisions of Part III of that Act, and Section 1 of the principal Act shall have effect as if, after the paragraph inserted therein by Section 42 of the Road Traffic Act, 1930, there were added the following paragraph:

(g) marine, aviation and transit insurance business, that is to say, the business of effecting and carrying out, otherwise than incidentally to some other class of assurance business, contracts of insurance—

- (i) upon vessels or aircraft, or upon the machinery, tackle, furniture or equipment of vessels or aircraft; or
- (ii) upon goods, merchandise or property of any description whatever on board vessels or aircraft; or
- (iii) upon the freight of, or any other interest in or relating to, vessels or aircraft; or
- (iv) against damage arising out of or in connection with the use of vessels or aircraft, including third party risks; or
- (v) against risks incidental to the construction, repair or docking of vessels, including third party risks; or
- (vi) against transit risks (whether the transit is by sea, inland water, land or air or partly one and partly another) including risks incidental to the transit insured from the commencement of the transit to the ultimate destination covered by the insurance, but not including risks the insurance of which is motor vehicle insurance business; or
- (vii) against any other risks the insurance of which is customarily undertaken in conjunction with or as incidental to any such business as is referred to in the foregoing provisions of this paragraph.

(2) In its application to marine, aviation and transit insurance business, the principal Act shall have effect subject to the following modifications:

- (a) Section 3 (which relates to the separation of funds) shall not apply;
- (b) the form of revenue account under paragraph (a) of Section 4 applicable to that business shall be the form set out in Part I of the First Schedule to this Act;
- (c) Sections 5 and 6 (which require the periodical making of an actuarial report on, and a statement of, the assurance business of the company) shall not apply;
- (d) the expressions 'policy' and 'policy holder', shall have the same meanings as they have in relation to accident insurance business;
- (e) at the end of the Sixth Schedule (which contains rules for valuing policies

and liabilities in a winding up) there shall be inserted the paragraph set out in Part II of the First Schedule to this Act.

(3) Paragraph (b) of subsection (1) of Section 33 of the principal Act (which exempts from that Act employers' liability insurance business carried on as incidental only to the business of marine insurance) shall cease to have effect, but, for the purposes of the principal Act and this Act, employers' liability insurance business shall not include any business carried on as incidental only to marine, aviation and transit insurance business.

2.—(1) Subject to the provisions of the Second Schedule to this Act, no person shall carry on in Great Britain assurance business of a class to which the principal Act applies except a company incorporated, whether under the Companies Act, 1929, or otherwise, and having a paid-up share capital of not less than fifty thousand pounds.

(2) If any person contravenes the provisions of subsection (1) of this section, then—

(a) in a case where that person is not a body corporate, he shall be liable on summary conviction to imprisonment for a term not exceeding three months, or on conviction on indictment to imprisonment for a term not exceeding two years; and

(b) in a case where that person is a body corporate—

(i) the body corporate may be wound up by the Court under the Companies Act, 1929, on a petition of the Board of Trade presented by leave of the Court; and

(ii) any director, manager, secretary or other officer or agent of the body corporate shall be liable to the penalty provided in paragraph (a) of this subsection, unless he proves that the contravention occurred without his knowledge or that he used all due diligence to prevent the occurrence thereof.

Rules made under Section 305 of the Companies Act, 1929, may regulate the procedure and the practice to be followed in the case of proceedings under subparagraph (i) of paragraph (b) of this subsection.

(3) Subject to the provisions of the said Second Schedule, the statutory declaration required by Section 94 of the Companies Act, 1929, to be delivered to the registrar of companies before a company to which that section applies commences business shall, in the case of a company registered after the commencement of this Act the objects whereof include the carrying on of assurance business of any class to which the principal Act applies, include a statement that not less than fifty thousand pounds of the company's share capital has been paid up.

3.—(1) Subject to the provisions of the Second Schedule to this Act, an assurance company carrying on general business shall be deemed, for the purposes of Section 168 of the Companies Act, 1929 (which authorises the Court to wind up a company unable to pay its debts), to be unable to pay its debts if the value of its assets does not exceed the amount of its liabilities by whichever is the greater of the following amounts, namely—

(a) fifty thousand pounds; or

(b) one-tenth of the general premium income of the company in its last preceding financial year;

and the Assurance Companies (Winding up) Acts, 1933 and 1935, shall apply accordingly:

Provided that, subject to the provisions as to existing companies contained in Part I of the Second Schedule to this Act, this section shall not apply to an assurance company unless and until a period of two years, or such longer period as the Board of Trade may in any case allow, has expired from the date of its commencing to carry on general business.

(2) For the purposes of this section—

(a) in computing the amount of the liabilities of an assurance company, all contingent and prospective liabilities shall be taken into account, but not liabilities in respect of share capital; and

- (b) the general premium income of an assurance company in any year shall be taken to be the net amount, after deduction of any premiums paid by the company for re-insurance, of the premiums received by the company in that year in respect of all assurance business (including business to which the principal Act does not apply) other than long-term business.
- (3) Regulations made by the Board of Trade may require that, in every balance sheet prepared under Section 4 of the principal Act by an assurance company carrying on general business, there shall be included a certificate—
 - (a) in such form and signed by such persons as may be prescribed by the regulations; and
 - (b) containing such a statement with respect to the assets and liabilities of the company as may be so prescribed for the purposes of this section; and if any such company fails to comply with the regulations so made, the value of its assets shall, in any proceedings under this section for the winding up of the company, be deemed, until the contrary is proved, not to exceed the amount of its liabilities by the amount required by subsection (1) of this section.
- (4) Nothing in this section shall be taken as affecting the manner in which, on a winding up, any assets or liabilities are required to be dealt with, whether by virtue of Section 3 of the principal Act or otherwise.

4.—(1) Subject to the provisions of the Second Schedule to this Act, no assurance company shall be required after the commencement of this Act to deposit any sum under Section 2 of the principal Act.

(2) The rules made by the Board of Trade under subsection (6) of the said Section 2 in respect of the withdrawal of deposits shall include provision for allowing an assurance company to withdraw any deposit made by it under that section, if the Board are satisfied in manner provided by the rules—

- (a) in the case of a company carrying on general business, whether with or without long-term business, that the value of the company's assets exceeds the amount of its liabilities by the amount required by Section 3 of this Act; and
 - (b) in the case of a company carrying on long-term business but not general business, either that it has a paid-up share capital of fifty thousand pounds or more, or—
 - (i) in the case of a company required to keep a separate fund or funds under Section 3 of the principal Act, that the value of the assets of the fund or of each such fund exceeds the amount of the liabilities to which it may be applied and that the excess, or, where more than one such fund is kept, the aggregate excess, is not less than fifty thousand pounds;
 - (ii) in the case of a company not so required, that the value of the company's assets exceeds the amount of its liabilities by fifty thousand pounds.
- (3) In computing liabilities for the purposes of paragraph (b) of the last foregoing subsection, all contingent and prospective liabilities shall be taken into account, but not liabilities in respect of share capital.

6. As respects—

- (a) the existing assurance companies mentioned in Part I of the Second Schedule to this Act; and
- (b) members of Lloyd's or of any such approved association as is mentioned in Part II of that Schedule; and
- (c) the mutual associations mentioned in Part III of that Schedule; and
- (d) the friendly societies and trade unions mentioned in Part IV of that Schedule; and
- (e) such assurance companies as are mentioned in Part V of that Schedule; the provisions respectively contained in the said Parts I to V shall have effect for adapting the operation of the principal Act and this Act to the special circumstances of those assurance companies and in particular for conferring exemptions from all or any of the provisions of that Act and this Act.

Section 1

SCHEDULES

FIRST SCHEDULE

MARINE, AVIATION AND TRANSIT INSURANCE BUSINESS

PART I

FORM OF REVENUE ACCOUNT

REVENUE ACCOUNT of.....for the year ended.....19....., in respect of MARINE, AVIATION AND TRANSIT INSURANCE BUSINESS

(being an account of income and expenditure in that year in respect of business arising (a) in that year, (b) in the last preceding year, and (c) in previous years)

	(a) Current Year	(b) Last Pre- ceding Year	(c) Pre- vious Years	Total		(a) Current Year	(b) Last Pre- ceding Year	(c) Pre- vious Years	Total
	£ s d	£ s d	£ s d	£ s d		£ s d	£ s d	£ s d	£ s d
Amount of Marine, Aviation and Transit insurance fund at beginning of the year									
Premiums less Brokerage, Discount, Commission, Returns and Re-insurances:									
Risks other than Aviation Hull risks ..									
Aviation Hull risks ..									
Other Income (to be specified) ..									
Loss transferred to Profit and Loss Account									
Claims paid (less Salvages, Refunds and Reinsurance Recoveries) (i)									
Risks other than Aviation Hull risks ..									
Aviation Hull risks ..									
Expenses of Management (ii) ..									
Other Expenditure (to be specified) ..									
Profit transferred to Profit and Loss Account ..									
Amount of Marine, Aviation and Transit insurance fund at end of year as shown in the Balance Sheet ..									

Notes.—

(i) This heading must include all expenses directly incurred in settling claims.

(ii) If any sum has been deducted from this item and entered on the assets side of the balance sheet, the amount so deducted must be shown separately in this account.

PART II

PARAGRAPH TO BE INSERTED AT END OF SIXTH SCHEDULE TO
PRINCIPAL ACT(F) *As respects Marine, Aviation and Transit Policies*
Rule for Valuing a Policy

The value of a current policy shall be such portion of the last premium paid as is proportionate to the unexpired portion of the period in respect of which the premium was paid:

Provided that this rule shall not apply to a policy of insurance upon goods, merchandise or property on board a vessel or aircraft or a policy of insurance against transit risks or risks incidental to transit, but any such policy shall be valued in like manner as it would have been valued if this Act had not passed.

SECOND SCHEDULE

ADAPTATIONS, &c., FOR SPECIAL CASES

PART I

EXISTING COMPANIES

1. Section 2 of this Act shall not apply to any assurance company which, immediately before the twenty-ninth day of October, nineteen hundred and forty-five, was carrying on in Great Britain assurance business of any class to which the principal Act applies, in compliance with such of the provisions of the principal Act as then applied to the company and to that class of business:

Provided that no such assurance company shall be an authorised insurer for the purposes of Section 16 of the Air Navigation Act, 1936, unless it is a body corporate having a paid-up share capital of not less than fifty thousand pounds as required by the said Section 2).

2. Section 3 of this Act shall not apply to any assurance company which at the commencement of this Act is carrying on general business (whether in Great Britain or elsewhere), before the expiration of the period of two years, or such longer period as the Board of Trade may in any case allow, from the commencement of this Act:

Provided that (notwithstanding anything in the foregoing provisions of this paragraph or in the said Section 3) in the case of any such assurance company which, immediately before the said twenty-ninth day of October, was carrying on in Great Britain assurance business of a class to which the principal Act applies—

- (a) if the company, within the said two years or longer period, withdraws in pursuance of rules made by virtue of Section 4 of this Act, any sum deposited under Section 2 of the principal Act, the said Section 3 shall apply to the company from the date of the withdrawal;
- (b) if the company, on or after the said twenty-ninth day of October and before the expiration of the said two years or longer period, has commenced or commences to carry on (whether in Great Britain or elsewhere) assurance business of any class to which the principal Act applies which it was not carrying on immediately before the said twenty-ninth day of October, the said Section 3 shall apply to the company from the commencement of this Act or from the time when it commences to carry on business of that class, whichever is the later.

PART II

LLOYD'S AND OTHER ASSOCIATIONS OF UNDERWRITERS

1. Sections 2 and 3 of this Act shall not apply to a member of Lloyd's or of an approved association to whom the principal Act does not apply by virtue of subsection (2) of Section 28 of the principal Act (which provides that that Act shall not apply to a member of Lloyd's or of an approved association who complies with the requirements of the Eighth Schedule to that Act).

2. The Committee of Lloyd's, and the managing body of an approved association, shall deposit every year with the Board of Trade a statement in such form as

may be prescribed by regulations made by the Board summarising the extent and character of the assurance business done by its members in the twelve months to which the statement relates; and the said regulations may require the statement to deal separately with such classes or descriptions of business as may be specified in the regulations.

3.—(1) As from such day as the Board of Trade may by order appoint, there shall be substituted for the said Eighth Schedule to the principal Act the following Schedule:

EIGHTH SCHEDULE

REQUIREMENTS TO BE COMPLIED WITH BY UNDERWRITERS BEING MEMBERS OF LLOYD'S OR OF ANY OTHER ASSOCIATION OF UNDERWRITERS APPROVED BY THE BOARD OF TRADE

1.—(1) Every underwriter shall, in accordance with the provisions of a trust deed approved by the Board of Trade, carry to a trust fund all premiums received by him or on his behalf in respect of any assurance business.

(2) Premiums received in respect of long-term business shall in no case be carried to the same trust fund under this paragraph as premiums received in respect of general business, but the trust deed may provide for carrying the premiums received in respect of all or any classes of long-term business and all or any classes of general business either to a common fund or to any number of separate funds.

2.—(1) The accounts of every underwriter shall be audited annually by an accountant approved by the Committee of Lloyd's or the managing body of the association, as the case may be, and the auditor shall furnish a certificate to the Committee or managing body and to the Board of Trade in such form as the Board may by regulations prescribe.

(2) The said certificate shall in particular state whether in the opinion of the auditor the value of the assets available to meet the underwriter's liabilities in respect of assurance business is correctly shown in the accounts, and whether or not that value is sufficient to meet the liabilities calculated—

(a) in the case of liabilities in respect of long-term business, by an actuary; and

(b) in the case of other liabilities, by the auditor on a basis approved by the Board of Trade.

(3) Where any liabilities of an underwriter are calculated by an actuary under the last foregoing sub-paragraph, he shall furnish a certificate of the amount thereof to the Committee of Lloyd's or the managing body of the association, as the case may be, and to the Board of Trade, and shall state in his certificate on what basis the calculation is made; and a copy of his certificate shall be annexed to the auditor's certificate.

3.—(1) The underwriter shall, when required by the Committee of Lloyd's or the managing body of the association, as the case may be, furnish to them such information as they may require for the purpose of preparing the statement as to the business done by its members which is to be deposited by them with the Board of Trade.

(2) The Board of Trade may make regulations providing for the manner in which deposits made, and premiums placed in a trust fund, under the provisions for which the Schedule set out in the foregoing sub-paragraph is to be substituted are to be dealt with on the said substitution taking effect, and for any other matters which appear to them to be incidental to or consequential on the said substitution; and the said regulations shall have effect notwithstanding anything in any trust deed made for the purposes of those provisions.

4. In this Part of this Schedule the expression 'approved association' means an association of underwriters approved by the Board of Trade under and for the purposes of subsection (2) of the said Section 28 of the principal Act.

PART III

MUTUAL ASSOCIATIONS

1.—(1) Where, on the application of any association of persons, whether incorporated or not, which, immediately before the twenty-ninth day of October, nineteen hundred and forty-five, was not carrying on in Great Britain assurance

business of any class to which the principal Act applies, the Board of Trade are satisfied that the association—

- (a) is about to carry on long-term business in Great Britain; and
- (b) is so constituted that the whole of the divisible surplus or profits thereof must, whenever determined or declared, be apportioned or applied for the benefit of the association's policy holders, or such of them as are entitled in accordance with the terms of the policies or any instruments governing the constitution of the association to participate in the profits of the association;

the Board may by order direct that the provisions of Section 2 of this Act shall not apply to the association on condition that it carries on no business other than long-term business and such other business (if any) as may be specified in the order.

(2) Where an order is made under this paragraph as respects any association, subsection (1) of Section 4 of this Act shall also not apply to the association.

2 Where, on the application of any association of persons, whether incorporated or not, the Board of Trade are satisfied that the association—

- (a) is carrying on or about to carry on fire insurance business; and
- (b) is not carrying on or about to carry on that business except for the purpose of the mutual insurance of its members against damage caused to buildings or other property owned or occupied by them;

the Board may by order direct that the provisions of Sections 2 and 3 of this Act (in so far as they would have applied to the association apart from the order) shall not apply to the association on condition that it carries on no business other than fire insurance business and business incidental thereto.

3.—(1) Where, on the application of any association of persons, whether incorporated or not, the Board of Trade are satisfied that the association—

- (a) is carrying on or about to carry on either employers' liability insurance business or marine, aviation and transit insurance business; and
- (b) is not carrying on or about to carry on that class of business except for the purpose of the mutual insurance of its members against risks incidental to their trade or industry.

the Board may by order direct that the provisions of Sections 2 and 3 of this Act and the provisions of the principal Act (in so far as they would have applied to the association apart from the order) shall not apply to the association on condition that it carries on no business other than employers' liability business or marine, aviation and transit insurance business, as the case may be, and business incidental thereto.

(2) An association as respects which an order is for the time being in force under this paragraph shall not be an authorised insurer—

- (a) for the purposes of Section 16 of the Air Navigation Act, 1936, unless it is a body corporate having a share capital of not less than fifty thousand pounds (as required by the said Section 2);

(3) Any order made under this paragraph in relation to an association carrying on or about to carry on employers' liability insurance business may be made so as to have effect as from the commencement of this Act.

4. Where a direction under this Part of this Schedule is given in respect of a company registered under the Companies Act, 1929, after the commencement of this Act, being a company which has not commenced business, the statutory declaration required by Section 94 of that Act to be delivered to the Registrar of Companies before the company commences business shall be accompanied by a copy, certified by the Board of Trade, of the order of the Board containing the direction, and that copy shall be filed by the Registrar.

5. Any order made under this Part of this Schedule may be revoked by the Board of Trade—

- (a) on the application of the association to which it applies; or
- (b) if the Board cease to be satisfied of the matters on the ground of which the order was made; or
- (c) if the Board are satisfied that the condition specified in the order has not been complied with.

- (b) by agreement with any person other than an electricity board and with the approval of the Central Authority, acquire bulk supplies of electricity from that person; and
- (c) by agreement with any other area board, supply electricity to consumers in the area of that other area board.

If any area board are unable to obtain the agreement of another area board under paragraph (c) of this subsection, they may apply to the Central Authority for an authorisation to supply electricity to consumers in such part of the area of that other area board as may be specified in the authorisation, and, if the Central Authority gives such an authorisation, the first-named area board shall have power to supply electricity in accordance therewith.

(5) The provisions of the last foregoing subsection shall apply in relation to the North of Scotland Board and the North of Scotland District as if that Board were an area board and that District were the area of an area board, subject to the modification that any approval of the acquisition of bulk supplies of electricity from any person in the North of Scotland District and any authorisation for the supply of electricity by an area board to consumers in the North of Scotland District shall be given by the Secretary of State.

(6) In exercising and performing their functions the Electricity Boards shall, subject to and in accordance with any directions given by the Minister or Secretary of State under this Part of this Act—

- (a) promote the use of all economical methods of generating, transmitting and distributing electricity;
- (b) secure, so far as practicable, the development, extension to rural areas and cheapening of supplies of electricity;
- (c) avoid undue preference in the provision of such supplies;
- (d) promote the simplification and standardisation of methods of charge for such supplies;
- (e) promote the standardisation of systems of supply and types of electrical fittings;

and shall also promote the welfare, health and safety of persons in the employment of the boards.

(7) As from the vesting date, the powers and duties of the North of Scotland Board under the Act of 1943, with regard to the generation of electricity by water power shall extend to the generation of electricity by any other means, and the North of Scotland District shall be altered so as to include the county of the city of Dundee, the whole of the counties of Angus and Perth and the county of Kinross, and so as to exclude the parish of Rosneath in the county of Dunbarton.

36.—(1) It shall be the duty of the Central Authority so to exercise and perform their functions under this Act, including their functions in relation to area boards, as to secure that the combined revenues of the Central Authority and all the area boards taken together are not less than sufficient to meet their combined outgoings properly chargeable to revenue account taking one year with another.

(2) Without prejudice to the powers of the Central Authority under Part I of this Act to exercise, by means of directions given to area boards, a general control over the policy of those boards in financial as in other matters, such directions may require area boards—

- (a) to submit for the approval of the Central Authority periodic estimates of revenue and expenditure;
- (b) to obtain the approval of the Central Authority of programmes of development involving capital expenditure, and of expenditure otherwise properly chargeable to capital account and in other classes of cases where it is desirable in the opinion of the Central Authority to secure co-ordination between different area boards in matters involving expenditure.

37.—(1) The prices to be charged by the Central Authority for the supply of electricity by them to area boards shall be in accordance with such tariffs as may be fixed by the Authority from time to time, and different tariffs may be fixed for different area boards.

(2) The tariffs fixed under the last foregoing subsection shall be so framed as to show the methods by which and the principles on which the charges are to be made as well as the prices which are to be charged, and shall be published in

such manner as in the opinion of the Central Authority will secure adequate publicity for them.

(3) Subject to any directions of the Central Authority and to the provisions of this Act with respect to railways, the prices to be charged by area boards for the supply of electricity by them shall be in accordance with such tariffs as may be fixed from time to time by them, and those tariffs shall be so framed as to show the methods by which and the principles on which the charges are to be made as well as the prices which are to be charged, and shall be published in such manner as in the opinion of the area board will secure adequate publicity for them:

Provided that—

(a) the tariffs in force immediately before the vesting date in the area of supply or any part of the area of supply of any authorised undertakers shall remain in force, until varied or replaced by tariffs fixed in accordance with this section, and apply to the supply of electricity by the area board within whose area the said area of supply or part thereof is comprised; and

(b) nothing in this subsection shall affect any agreement in force immediately before the vesting date.

(4) A tariff fixed by an area board under the last foregoing subsection may include a rent or other charge in respect of electrical fittings provided by the board on the premises of the consumer.

(5) The Central Authority may give directions to any area board requiring them, in such classes of cases as may be specified in the directions, to obtain the approval in writing of the Central Authority before exercising their powers under the foregoing provisions of this section.

(6) The Central Authority may, if they consider that the tariffs in force in the area or any part of the area of an area board ought to be varied or replaced by new tariffs, direct the area board to submit proposals for varying or replacing those tariffs, and may approve the proposals so submitted either without modifications or with such modifications as, after consultation with the area board, they think fit to make; and it shall be the duty of the area board to give effect to any proposals approved under this subsection.

(7) Notwithstanding anything in the foregoing provisions of this section, an area board may enter into an agreement with any consumer for the supply of electricity to him on such terms as may be specified in the agreement:

Provided that an area board, in exercising their powers under this subsection, shall—

(a) secure that such agreements are only made in cases where the tariffs in force are not appropriate owing to special circumstances; and

(b) comply with any directions given by the Central Authority, whether of a general or specific character.

(8) An area board, in fixing tariffs and making agreements under this section, shall not show undue preference to any person or class of persons and shall not exercise any undue discrimination against any person or class of persons, and the Central Authority shall, in exercising their powers under this section in relation to the fixing of tariffs and making of agreements by area boards, secure compliance by area boards with this subsection.

43.—(1) The Central Authority shall establish and maintain a general reserve fund, which shall be known as the central reserve fund.

(2) The Central Authority and the area boards shall contribute to the central reserve fund such sums at such times as the Central Authority may determine and the management of the said fund and the application of the moneys comprised therein shall be as the Central Authority may determine:

Provided that—

(a) no part of the said fund shall be applied otherwise than for the purposes of the Central Authority and area boards; and

(b) the power of the Minister to give directions to the Central Authority shall extend to the giving to them, with the approval of the Treasury, of directions as to any matter relating to the establishment or management of the said fund, the carrying of sums to the credit thereof, or the application thereof, notwithstanding that the directions may be of a specific character.

(3) Any area board may establish a general reserve fund for the purposes of the area board, which shall be known as an area reserve fund.

(4) If an area board establish an area reserve fund, they shall, from their surplus revenue, contribute to the said fund, to such extent as the Central Authority may approve, and the management of the said fund and the application of the moneys comprised therein shall be as the area board may determine;

Provided that—

- (a) no part of the fund shall be applied otherwise than for the purposes of the area board; and
 - (b) the power of the Central Authority to give directions to any area board shall extend to the giving to them, with the approval of the Minister, of directions as to any matter relating to the establishment or management of the area reserve fund or the carrying of sums to the credit thereof, notwithstanding that the directions may be of a specific character.
- (5) The foregoing provisions of this section shall be without prejudice to the power of the Central Authority or any area board to establish appropriate reserves for replacements or other purposes:

Provided that an area board shall act in regard to the establishment, management and application of any such reserve in accordance with any directions of the Central Authority, whether of a general or specific character.

(6) It is hereby declared that one of the purposes of the central reserve fund and the area reserve funds is the prevention of frequent fluctuations in the charges made by the Central Authority and the area boards, and the powers of that Authority and those boards in relation of those funds shall be exercised accordingly.

44.—(1) Any excess of the Central Authority's revenues for any financial year over their outgoings for that year properly chargeable to revenue account shall be applied for such purposes as the Authority may determine:

Provided that—

- (a) no part of any such excess shall be applied otherwise than for the purposes of the Authority or any area board; and
 - (b) the power of the Minister to give directions to the Authority shall extend to the giving to them, with the approval of the Treasury, of directions as to the application of any such excess, notwithstanding that the directions may be of a specific character.
- (2) Any excess of any area board's revenues for any financial year over their outgoings for that year properly chargeable to revenue account shall be applied for such purposes of the area board as the board may, with the approval of the Central Authority, determine.

45. The Central Authority and the area boards shall charge to revenue account in every year all charges which are proper to be made to revenue account, including, in particular, proper allocations to the central reserve fund (but not including, in the case of an area board, allocations to an area reserve fund), proper provision for the redemption of capital and proper provision for depreciation of assets or for renewal of assets, and all payments (including the payments which are by the relevant provision of this Act, or by any other relevant enactment, to be deemed to be capital payments) which fall to be made in that year to any local authority under Part II of this Act in respect of any loan of that local authority, and references in this Act to outgoings properly chargeable to revenue account shall be construed accordingly.

46.—(1) The Central Authority and each area board shall keep proper accounts and other records in relation to the business of that Authority or the business of that board, as the case may be, and shall prepare in respect of each financial year a statement of accounts in such form as the Minister, with the approval of the Treasury, may direct, being a form which shall conform with the best commercial standards.

(2) The form of the said statement shall be such as to secure the provision of separate information as respects the generation of electricity, the distribution of electricity, and each of the main other activities of the Electricity Board concerned, and to show as far as may be the financial and operating results of each such activity.

(3) The accounts of the Central Authority and of every area board shall be audited by auditors to be appointed in respect of each financial year by the Minister:

Provided that no person shall be qualified to be so appointed unless he is a member of one or more of the following bodies:

The Institute of Chartered Accountants in England and Wales;
 The Society of Incorporated Accountants and Auditors;
 The Society of Accountants in Edinburgh;
 The Institute of Accountants and Actuaries in Glasgow;
 The Society of Accountants in Aberdeen;
 The Association of Certified and Corporate Accountants Limited.

(4) So soon as the accounts of any area board have been audited, they shall send the statement of their accounts referred to in subsection (1) of this section to the Central Authority together with a copy of any report made by the auditors on that statement or on the accounts of the board.

(5) So soon as the accounts of the Central Authority have been audited, they shall send a copy of the statement of their accounts referred to in subsection (1) of this section to the Minister together with a copy of any report made by the auditors on that statement or on the accounts of the Authority and shall also send copies of the statements of accounts of every area board to the Minister together with any reports on those statements or accounts as aforesaid, and copies thereof shall be made available to the public at a reasonable price.

(6) The Minister shall lay a copy of every such statement and report before each House of Parliament.

GAS ACT, 1948

11 & 12 Geo. 6, Ch. 67

1.—(1) There shall be established boards, to be known by the names mentioned in the first column of the First Schedule to this Act and in this Act referred to as 'Area Boards', for the areas which are described in general terms in the second column of that Schedule and are to be defined by orders made under this Part of this Act, and it shall be the duty of every area board as from the vesting date—

- (a) to develop and maintain an efficient, co-ordinated and economical system of gas supply for their area and to satisfy, so far as it is economical to do so, all reasonable demands for gas within their area;
- (b) to develop and maintain the efficient, co-ordinated and economical production of coke, other than metallurgical coke, by them;
- (c) to develop and maintain efficient methods of recovering by-products obtained in the process of manufacturing gas.

(2) Every area board shall have power to carry on all such activities as it may appear to the board to be requisite, advantageous or convenient for them to carry on for or in connection with the discharge of their duties under the preceding subsection or with a view to making the best use of any assets vested in them by or under this Act, and in particular, but without prejudice to the generality of the preceding provision—

- (a) to manufacture gas, to acquire gas in bulk from any person including another area board, and to supply gas in bulk to another area board;
- (b) to distribute gas in their area;
- (c) to manufacture, treat, render saleable, supply or sell—
 - (i) coke and other solid fuels obtained by carbonisation;
 - (ii) any by-products obtained in the process of manufacturing gas, coke or any such other solid fuels as aforesaid; and
 - (iii) any products made or derived from gas, coke or any such other solid fuel as aforesaid or from any by-product obtained as aforesaid;
- (d) to sell, hire or otherwise supply gas fittings and coke fittings and to install, repair, maintain or remove gas fittings and coke fittings and plant required by the board or any other area board;
- (e) after consultation with the Gas Council established under the next following section, to manufacture plant required by the board or any other area board and to manufacture gas fittings and coke fittings, except for export:

Provided that an area board shall not exercise their powers under paragraph (e) hereof unless they are satisfied that the available facilities for obtaining at reasonable prices plant required by them or any other area board or gas fittings or coke fittings are or may become inadequate.

(5) Any interest arising from the investment of moneys in the fund shall be paid into the fund, except when the sums standing to the credit of the fund have reached the sum of five million pounds, and shall in that case be distributed to the area boards and the Gas Council in such shares as may be determined by the Gas Council, having regard to the extent of their respective contributions to the fund.

(6) Where any area board fail to discharge their obligations in respect of any such payments as are referred to in paragraph (a) of subsection (1) of this section or in respect of contributions which they are required to make to the central guarantee fund, the Gas Council may, with the approval of the Minister, give directions to the area board with respect to the management or policy of the board, including tariffs and other financial matters, during such period as the Minister after consultation with the Gas Council and the area board may determine, being a period which extends at least until the said obligations (including any contributions required to be made to the central guarantee fund in respect of the default) have been met, and the area board shall give effect to any such directions.

47.—(1) Each area board and, if and so long as they exercise their powers to manufacture plant, gas fittings or coke fittings, the Gas Council shall establish and maintain a general reserve fund for the purposes of the area board or the Gas Council as the case may be.

(2) The area board or the Gas Council, as the case may be, shall contribute to the said fund to such extent as they may determine, and the management of the said fund and the application of the moneys comprised therein shall be such as they may determine:

Provided that—

- (a) no part of the reserve fund so established by an area board shall be applied otherwise than for the purposes of the board and no part of the reserve fund so established by the Gas Council shall, so long as it is required to be maintained, be applied otherwise than for purposes connected with the manufacture of plant or fittings by them; and
 - (b) the power of the Minister to give directions to any area board and to the Gas Council shall extend to the giving to them with the approval of the Treasury of directions as to any matter relating to the establishment of a reserve fund by the board or Council under this section, the management thereof, the carrying of sums to the credit thereof or the application thereof, notwithstanding that the directions may be of a specific character.
- (3) The preceding provisions of this section shall be without prejudice to the power of area boards and of the Gas Council to make appropriate provision for replacements or other purposes.

48.—(1) The Gas Council may require any area board from time to time to contribute such sums as the Council, with the approval of the Minister, may determine, towards meeting the expenses of the Council, other than expenses in respect of the manufacture of plant, gas fittings or coke fittings, and the area board shall comply with that requirement.

(2) Any sums contributed by an area board under this section towards meeting the expenses of the Gas Council in respect of interest on any British Gas Stock or any temporary loan shall be deemed to be annual payments, and any sums so contributed towards meeting the expenses of the Council in respect of the redemption of any such stock or loan shall be deemed to be capital payments.

49. Each area board and the Gas Council shall charge to revenue account in every year all charges which are proper to be made to revenue account, including, in particular, proper allocations to the central guarantee fund and to any reserve fund kept by the board or Council under Section 47 of this Act, proper provision for the redemption of capital and proper provision for depreciation of assets or for renewal of assets, and all payments (including the payments which are by the relevant provisions of this Act, or by any other relevant enactment, to be deemed to be capital payments) which fall to be made in that year to any local authority under Part II of this Act in respect of any loan or advance of that local authority, and references in this Act to outgoings properly chargeable to revenue account shall be construed accordingly.

50.—(1) Each area board and the Gas Council shall keep proper accounts and

other records in relation to the business of that board or the Council, as the case may be, and shall prepare in respect of each financial year a statement of accounts in such form as the Minister, with the approval of the Treasury, may direct, being a form which shall conform with the best commercial standards.

(2) The form of the said statement shall be such as to secure the provision of separate information as respects each of the main activities of the board concerned or of the Council, and to show as far as may be the financial and operating results of each such activity.

(3) The accounts of every area board and of the Gas Council shall be audited by auditors to be appointed in respect of each financial year by the Minister:

Provided that no person shall be qualified to be so appointed unless he is a member of one or more of the following bodies:

The Institute of Chartered Accountants in England and Wales;

The Society of Incorporated Accountants and Auditors;

The Society of Accountants in Edinburgh;

The Institute of Accountants and Actuaries in Glasgow;

The Society of Accountants in Aberdeen;

The Association of Certified and Corporate Accountants;

The Institute of Chartered Accountants in Ireland.

(4) Every area board and the Gas Council shall as soon as their accounts have been audited, send a copy of the statement thereof referred to in subsection (1) of this section to the Minister together with a copy of any report made by the auditors on that statement or on those accounts, and copies of those statements and of every such report shall be made available to the public at a reasonable price.

(5) The Minister shall lay a copy of every such statement and report before each House of Parliament.

METROPOLIS WATER ACT, 1902

2 *Edw. 7 Ch. 41*

Establishment of Water Board

1.—(1) A board, to be called the Metropolitan Water Board, and in this Act referred to as 'the Water Board', shall be established for the purpose of acquiring by purchase and of managing and carrying on the undertakings of the companies mentioned in the First Schedule to this Act (in this Act referred to as 'metropolitan water companies'), and generally for the purpose of supplying water within the area described in the Second Schedule to this Act, subject to such alterations therein as may be made by or under this Act (which area is in this Act referred to as 'the limits of supply').

(2) The Water Board shall be a body corporate with a common seal, having power to acquire and hold land for the purposes of this Act without licence in mortmain.

19. The accounts of the Water Board, and any committee appointed by them and of their officers, shall be made up and audited in like manner, and subject to the same provisions, as the accounts of county councils, except that a water consumer shall have the same right of being present at the audit, and of making objections and appealing, as a ratepayer has, and that the stamp duty charged on the Water Board for the purposes of the District Auditors Act, 1879, shall be such as the Treasury after consultation with the Local Government Board, and having regard to the cost of the audit, may determine, and the enactments relating to the accounts of county councils and the audit thereof, and to all matters incidental thereto and consequential thereon, including the penal provisions, shall apply accordingly.

20.—(1) At the beginning of every financial year the Water Board shall cause to be submitted to them an estimate of the receipts and expenditure of such Board during that financial year whether on account of property, contributions, rates, loans, or otherwise.

(2) All payments to and out of the water fund shall be made to and by the treasurer of the Water Board, and all payments out of the fund shall be made

in pursuance of an order of the Water Board signed by three members of the finance committee present at the meeting of the Board and countersigned by the clerk of the Board, and the same order may include several payments.

Moreover all cheques for the payment of money issued in pursuance of such order shall be countersigned by the clerk of the Board, or by a deputy approved by the Board.

(3) The Water Board shall from time to time appoint a finance committee for regulating and controlling their finance, and an order for the payment of a sum out of the water fund whether on account of capital or income shall not be made by the Water Board except in pursuance of a resolution of the Board passed on the recommendation of the finance committee, and any costs, debt, or liability exceeding fifty pounds shall not be incurred except upon a resolution of the Board passed on an estimate submitted by the finance committee.

(4) The notice of the meeting at which any resolution for the payment of a sum out of the water fund (otherwise than for ordinary periodical payments), or any resolution for incurring any costs, debt, or liability exceeding fifty pounds, will be proposed, shall state the amount of the said sum, costs, debt, or liability and the purposes for which they are to be paid or incurred.

28. The Water Board shall make to the Local Government Board an annual report of their proceedings, and this report shall be laid annually before Parliament by the Local Government Board. The Water Board shall also give to the Local Government Board such returns, statistics, and information, with respect to the exercise of the powers of the Water Board as the Local Government Board may require.

THE WATER ACT, 1945 8 & 9 Geo. 6 Ch. 42

32.—(1) The Minister may by any order made under Section 9, Section 10, Section 12, Section 23 or Section 40 of this Act apply to any water undertaking to which the order relates such of the provisions contained in the Third Schedule to this Act as appear to him to be appropriate, subject to such modifications and adaptations as may be specified in the order.

(2) The Minister may at any time by order apply the provisions of the Third Schedule to this Act or any of them to the undertaking of any statutory water undertakers supplying water under a local enactment, subject to such modifications and adaptations as may be specified in the order, and may by the order repeal any provision previously applicable to the undertaking to the extent to which it appears to him, having regard to the provisions of this Act which apply, or are applied by the order, to the undertaking, to be no longer required, or amend any provision previously applicable to the undertaking to any extent which appears to him necessary to bring it into conformity with the said provisions of this Act:

Provided that, during the period of five years beginning with the commencement of this Act, he shall not make such an order except on the application of the undertakers concerned.

(3) The provisions of Part I of the First Schedule to this Act shall apply to orders made under the last foregoing subsection on the application of the undertakers concerned, and the provisions of Part II of the said Schedule shall apply to orders made thereunder without any such application, and all orders made under the said subsection shall, in the circumstances specified in paragraph 8 or paragraph 17, as the case may be, of the said Schedule, be provisional only and not have effect until they are confirmed by Parliament.

(4) The Minister, when considering the making of an order under subsection (2) of this section, shall have regard to the powers, if any, and practice of the undertakers as regards additional charges in respect of water-closets and baths, and the probable effect of any order made by him on the financial position of the undertaking and on the rates and charges payable by consumers of different classes.

(5) Where the Minister makes an order under subsection (2) of this section, he shall, if so requested by the undertakers concerned before the order is made, postpone the operation of the order for such period as he deems sufficient to

enable them to make an application to him under Section 40 of this Act (which relates to the power of the Minister to revise water rates and charges).

42.—(1) Where statutory water undertakers are a company, they shall in each year after that in which they commence to supply water, or, if they are supplying water at the commencement of this Act, in each year after the commencement thereof, prepare in such form as the Minister may direct an abstract of the accounts of their undertaking for the preceding year showing under the appropriate heads their income and expenditure, the amount standing to the credit of any reserve or contingency fund and the balances brought forward and carried forward respectively, and the abstract so prepared shall be signed by the chairman of the undertakers and certified by the auditors of the undertaking.

(2) A copy of the said abstract so signed and certified shall be transmitted forthwith to the Minister and to the clerk of the local authority of every county and district within which the undertakers supply water or have any waterworks.

(3) If any of the foregoing provisions of this section is not complied with, the undertakers shall in respect of each offence be liable on summary conviction to a fine not exceeding twenty pounds.

THIRD SCHEDULE

PART XV

FINANCIAL PROVISIONS APPLICABLE TO WATER COMPANIES

74.—(1) Subject to the provisions of this section, where the undertakers are a company, they shall not in respect of any year pay dividends on the paid-up capital of their undertaking, at rates per cent. greater than the following rates, that is to say:

- (a) on capital subscribed before the date on which this section comes into force, the rates which they were entitled to pay thereon immediately before that date; and
- (b) on capital subscribed after that date, five per cent. or, in the case of such capital entitled by the terms of subscription to a rate of dividend lower than five per cent., that lower rate.

(2) Nothing in the last foregoing subsection shall prevent the payment of a greater dividend in order to make up deficiencies in previous dividends:

Provided that, as respects capital subscribed after the date on which this section comes into force, this subsection shall apply only in relation to deficiencies arising during the last five years before the year in respect of which a dividend is being paid.

(3) Paragraph (1) of subsection (1) of Section 1 of the Trustee Act, 1925 (which includes among trustee stocks any debenture, guarantee or preference stocks of water undertakers, being a company incorporated by special Act of Parliament or by Royal Charter, if for the previous ten years the company has paid a dividend of not less than five per centum on its ordinary stock) shall apply in a case where the undertakers are incorporated by statutory order as well as in a case where they are such a company as is referred to in that paragraph, and shall have effect, in any case to which the paragraph as extended by this subsection applies, as if for the words 'five per centum' there were substituted the words 'four per centum.'

75.—(1) Where the undertakers are a company, all ordinary and preference stock issued by them shall be issued in accordance with the following provisions of this section.

(2) All stock issued by the undertakers shall be offered for sale by public auction or tender in such manner, at such times and subject to such conditions of sale as the undertakers from time to time determine:

Provided that—

- (a) notice of the intended sale shall be given in writing to the local authority of every district wholly or partly within their limits of supply and to the secretary of the London Stock Exchange at least seven days before the day of auction or the last day for the reception of tenders, as the case may be, and shall be advertised once in each of two successive weeks in one or more local newspapers circulating within the limits of supply;

- (b) a reserve price shall be fixed and notice thereof shall be sent by the under-

takers in a sealed letter to be received by the Minister not less than twenty-four hours before, but not to be opened until after, the day of auction or the last day for the receipt of tenders, as the case may be;

- (c) in the case of a sale by auction, no lot offered for sale shall comprise stock of greater nominal value than one hundred pounds;
- (d) in the case of a sale by tender, no preference shall be given to one of two or more persons tendering the same sum, except that the offer by tender of any holder of stock of the undertakers may be accepted in preference to the offer of the same sum by any person who is not such a holder as aforesaid and preference may in like manner be given to the offer of any employee of the undertakers or consumer of water supplied by the undertakers;
- (e) in the case of a sale by auction a bid (other than a first bid) shall not be recognised unless it is in advance of the last preceding bid; and
- (f) it shall be one of the conditions of sale that the total sum payable by the purchaser shall be paid to the undertakers within three months after the date of the auction or of the acceptance of the tender, as the case may be.

(3) Any stock which has been offered for sale in accordance with the last foregoing subsection and is not sold may be disposed of at such price and in such manner as the undertakers may determine for the purpose of realising the best price obtainable.

(4) As soon as possible after the conclusion of the sale or sales, the undertakers shall send a report thereof to the Minister stating the total amount of each class of stock sold, the total amount obtained as premium (if any) and the highest and lowest prices obtained for each class of stock.

76.—(1) Where the undertakers are a company, they may, subject to the provisions of this section, by setting apart in any year out of revenue such sums as they think fit, form and maintain—

- (a) a reserve fund, for the purpose of making good any deficiency which may at any time occur in the amount of divisible profits, or of meeting any extraordinary claim or demand which may at any time be made upon them;
- (b) a contingency fund, for the purpose of meeting contingencies, or defraying the cost of renewing, repairing, enlarging or improving any part of the works forming part of the undertaking.

(2) Any sums so set apart for the formation or maintenance of a reserve or contingency fund may from time to time be invested in securities in which trustees are authorised to invest trust moneys, and, subject to the provisions of the next but one succeeding subsection, the dividends and interest arising from such securities may also be invested in the same or like securities so as to accumulate at compound interest for the credit of the fund in question.

(3) The undertakers shall transfer to any reserve fund or contingency fund formed under the foregoing provisions of this section any sum then standing to the credit of any existing reserve fund or contingency fund, as the case may be.

(4) Whenever, and so long as, the aggregate amount standing to the credit of the reserve fund and contingency fund together amounts to (or, by reason of such a transfer as aforesaid, exceeds) a sum equal to twelve and a half per cent. of the capital expenditure theretofore incurred by the undertakers for the purposes of their undertaking, no contribution from the revenue of the undertaking shall be made to either of the funds, and the interest and dividends on the funds shall not be invested but shall be treated as income of the undertaking.

(5) The aggregate amount which, subject to the provisions of the last foregoing subsection, may be carried by the undertakers in any year to the formation or maintenance of the reserve fund and contingency fund shall not exceed a sum equal to one and a quarter per cent. of the capital expenditure theretofore incurred by the undertakers for the purposes of their undertaking.

77.—(1) Where the undertakers are a company, it shall not be lawful for them to carry forward at the end of any year to the credit of the profit and loss (net revenue) account any sum exceeding the total of the following amounts, that is to say:

- (a) the amount required for paying any dividend or interest which they are entitled, or required, to pay, but have not paid, in respect of that year;
- (b) an amount equal to the total sum which they will be required to pay

during the next following year as interest on any mortgages or debenture stock; and

- (c) an amount equal to the total sum which they might lawfully distribute as dividends on the preference and ordinary capital of the undertaking in respect of the next following year.
- (2) Any sum which, but for the provisions of this section, might at the end of any year have been so carried forward as aforesaid shall be applied towards the reduction of water rates and charges in future years.

78.—(1) Where the undertakers are a company, they may—

- (a) grant gratuities, pensions or superannuation allowances to, or to the widows, families or dependants of, their employees;
- (b) establish contributory superannuation schemes, and establish and contribute to superannuation funds for the benefit of their employees;
- (c) enter into and carry into effect agreements with any insurance company or other association or company for securing to any such employee, widow, family or dependant such gratuities, pensions or allowances as are by this section authorised to be granted;
- (d) give donations or subscriptions to charitable institutions, sick funds, benevolent funds and other objects calculated to benefit their employees;
- (e) subscribe to the funds of any association formed for the purpose of furthering the interests of water undertakers;
- (f) make contributions for furthering research in matters with which water undertakers and their officers are concerned.
- (2) No employee of the undertakers shall be required to become a contributor to any superannuation fund established under this section until the fund has been registered under the Superannuation and other Trust Funds (Validation) Act, 1927.

THE WATER ACT, 1948

11 & 12 Geo. 6, Ch. 22

7.—(1) Subsection (1) of Section 42 of the principal Act (which requires statutory water undertakers being companies to prepare annual abstracts of the accounts of their undertakings) shall have effect as if the words 'in such form as the Minister may direct', were omitted, and as if at the end of the subsection there were added the following paragraph:

'The Minister may give directions as to the form of the abstracts to be prepared by statutory water undertakers under this subsection, and such directions may be given either in relation to any particular undertakers or in relation to all undertakers of any specified class.'

(2) Subsection (2) of the said Section 42 (which requires such undertakers as aforesaid to transmit to the Minister and to certain local authorities copies of the abstracts prepared under that section) shall have effect as if after the word 'certified' there were inserted the words 'and a copy of the balance sheet of the undertakers for the year to which the abstract relates.'

THE TRANSPORT ACT, 1947

10 & 11 Geo. 6, Ch. 49

1.—(1) For the purposes of this Act, there shall be a public authority to be called the British Transport Commission (in this Act referred to as 'the Commission').

(2) The Commission shall consist of a chairman and not less than four nor more than eight other members, all of whom shall be appointed by the Minister from among persons appearing to him to be persons who have had wide experience and shown capacity in transport, industrial, commercial or financial matters, in administration, or in the organisation of workers, and of whom the chairman and not less than four other members shall be required to render whole-time service to the Commission.

(3) Every member of the Commission shall hold and vacate his office in

accordance with the terms of his appointment and shall, on ceasing to be a member, be eligible for reappointment:

Provided that any member may at any time by notice in writing to the Minister resign his office.

(4) A person shall be disqualified for being appointed or being a member of the Commission so long as he is a member of the Commons House of Parliament.

(5) Before appointing a person to be a member of the Commission, the Minister shall satisfy himself that that person will have no such financial or other interest as is likely to affect prejudicially the discharge by him of his functions as a member of the Commission and the Minister shall also satisfy himself from time to time with respect to every member of the Commission that he has no such interest; and any person who is, or whom the Minister proposes to appoint to be, a member of the Commission shall, whenever requested by the Minister so to do, furnish to him such information as the Minister considers necessary for the performance by the Minister of his duties under this subsection.

(6) A member of the Commission who is in any way directly or indirectly interested in a contract made or proposed to be made by the Commission shall disclose the nature of his interest at a meeting of the Commission; and the disclosure shall be recorded in the minutes of the Commission, and the member shall not take any part in any deliberation or decision of the Commission with respect to that contract.

(7) The Commission—

- (a) shall pay to the members thereof such salaries or fees, and such allowances, as the Minister may, with the approval of the Treasury, determine; and
- (b) on the retirement or death of any of the members as to whom the Minister may, with the approval of the Treasury, determine that such provision should be made, shall pay to or in respect of them such pensions as he may so determine.

(8) The Minister shall, as soon as may be after the first appointment of any person as a member of the Commission, lay before each House of Parliament a statement of the salary or fees and of the allowances which the Commission are required to pay to that person under the last preceding subsection.

(9) The provisions of the First Schedule to this Act shall have effect with respect to the Commission.

88.—(1) The Commission may, with the consent of the Minister, or in accordance with the terms of any general authority given by him, borrow temporarily, by way of overdraft or otherwise, such sums as the Commission may require for meeting their obligations or discharging their functions under this Act:

Provided that the aggregate of the amounts outstanding in respect of any temporary loans raised by the Commission under this subsection shall not at any time exceed twenty-five million pounds.

(2) The Commission may, with the consent of the Minister and the approval of the Treasury, borrow money by the issue of British transport stock for all or any of the following purposes, that is to say—

- (a) the provision of money for meeting any expenses incurred in connection with any permanent work the cost of which is properly chargeable to capital;
- (b) the redemption of any British transport stock;
- (c) the provision of working capital;
- (d) the provision of money required to satisfy any right to compensation in respect of the transfer to the Commission of the whole or any part of an undertaking which, under any provision of this Act, is to be defrayed in cash, not being money required to pay compensation to officers or servants or to make to a local authority periodical payments in respect of any of their securities;
- (e) the purchase, otherwise than simply by way of investment, of any securities of any body corporate which is carrying on or about to carry on or which directly or indirectly controls another body corporate which is carrying on or about to carry on, any such activities as are specified in subsection (1) of Section 2 of this Act;
- (f) the provision of any money, not being money properly chargeable to revenue, which is required for lending to, or is required to be paid under

any guarantee given for the benefit of, any such body corporate as is mentioned in the last preceding paragraph or any other person who is carrying on or about to carry on any such activities as are therein mentioned;

- (g) any other purpose for which capital moneys are properly applicable, including the repayment of any money temporarily borrowed under subsection (1) of this section for any of the purposes mentioned in the preceding paragraphs of this subsection:

Provided that the total amount borrowed under this subsection, otherwise than for the purposes specified in paragraphs (b) and (d) thereof, shall not exceed two hundred and fifty million pounds.

The reference in paragraph (d) of this subsection to any provision of this Act includes a reference to any provision thereof applied, with or without modifications, by any scheme or order under this Act.

- (3) Save as aforesaid, the Commission shall not borrow any money.

92.—(1) Without prejudice to the power of the Commission to establish appropriate reserves for replacements or other purposes, the Commission shall establish and maintain a general reserve.

(2) The management of the general reserve, the sums to be carried from time to time to the credit thereof, and the application of the moneys comprised therein shall be as the Commission may determine:

Provided that—

- (a) no part of the moneys comprised in the general reserve shall be applied otherwise than for the purposes of the Commission; and

- (b) the Minister may, with the approval of the Treasury, give to the Commission directions as to any matter relating to the establishment or management of the general reserve or the carrying of sums to the credit thereof, or the application thereof, and the Commission shall give effect to any such directions.

(3) It is hereby declared that one of the purposes of the general reserve is the prevention of frequent fluctuations in the charges made by the Commission, and the powers of the Commission in relation to the general reserve shall be exercised accordingly.

93. The Commission shall charge to revenue in every year all charges which are proper to be made to revenue, including, in particular, proper allocations to general reserve, proper provision for depreciation or renewal of assets and proper provision for redemption of capital, and all payments (including the payments which are by the relevant provisions of this Act, or by any other relevant statutory provision, to be deemed to be capital payments) which fall to be made, in lieu of any other form of compensation, to any local authority in that year in respect of any undertaking transferred to the Commission, and references in this Act to charges properly chargeable to revenue shall be construed accordingly.

94.—(1) The Commission—

- (a) shall cause proper accounts and other records in relation thereto to be kept; and

- (b) shall prepare an annual statement of accounts in such form and containing such particulars, compiled in such manner, as the Minister may from time to time direct with the approval of the Treasury.

(2) The said annual statement shall be so framed as to provide, as far as may be, separate information as respects the principal activities of the Commission, and, in combination with the periodical statistics and returns rendered by the Commission, to show, as far as may be, the financial and operating results of each such activity, and the Minister and the Treasury shall exercise their powers under this section accordingly.

(3) The accounts of the Commission shall be audited by an auditor or auditors to be appointed annually by the Minister and in accordance with a scheme of audit approved by him and, if the Minister so directs, the accounts of the Commission as respects any part of their undertaking specified in the direction shall be separately audited by an auditor or auditors so appointed as aforesaid.

(4) So soon as the accounts of the Commission have been audited as aforesaid, they shall send a copy of the statement of accounts referred to in paragraph (b)

of subsection (1) of this section to the Minister, together with a copy of the report made by the auditor or auditors on that statement, and a copy of that statement and of any such report shall be included in the report which is under Part I of this Act to be laid by the Minister annually before each House of Parliament.

(5) The Commission shall compile and render to the Minister such periodical statistics and returns relating to each of their principal activities in such forms and at such times as the Minister may direct, and the Minister shall lay a copy of any such statistics and returns before each House of Parliament:

Provided that, in giving any directions under this subsection, the Minister shall have regard to the desirability of requiring the Commission to compile and render statistics and returns on a basis which, in his opinion, is reasonably comparable with that of the statistics and returns required at the date of the passing of this Act to be rendered by railway and canal companies by or under the enactments mentioned in the next succeeding subsection.

(6) Sections 9 and 10 of the Regulation of Railways Act, 1871, Sections 32 and 39 of the Railway and Canal Traffic Act, 1888, the Railway Companies (Accounts and Returns) Act, 1911, and Section 77 of the Railways Act, 1921 (which relate to the keeping of and audit of accounts of railway companies, and the making of returns and the keeping of statistics by railway and canal companies), and, except in so far as the Minister may by order otherwise provide, so much of any other statutory provision as relates to the accounts, statistics and returns to be kept or made by the owners of undertakings transferred to the Commission (whether in whole or in part and whether by agreement or otherwise), or as relates to the audit or publication of any such accounts, shall not apply to the Commission.

TRANSPORT ACT, 1947

FORM OF ANNUAL STATEMENT OF ACCOUNTS TO BE RENDERED BY THE BRITISH TRANSPORT COMMISSION

The Minister of Transport in exercise of the powers conferred upon him by Section 94 of the Transport Act, 1947, and of all other powers him enabling and with the approval of the Treasury, hereby directs as follows:

Until he otherwise directs—

(a) the annual statement of accounts of the Commission shall be made up as at 31st December, 1948, and as at the close of each calendar year thereafter, and shall consist of a consolidated revenue account and a consolidated balance sheet;

(b) the consolidated revenue account shall consist of:

(i) A statement of revenue receipts and expenditure showing the consolidated working results for the year, before providing for the charges to be shown in the net revenue account as mentioned in (ii) below. Such statement shall show separately the aggregate working results of the principal carrying activities and of other principal activities, the earnings of subsidiary companies not engaged in the principal activities of the Commission and income from non-controlled undertakings and other sources. There shall be shown separately in this statement the respective totals of—

(a) central administration expenses;

(b) interest on British Transport stock and other interest charges;

(c) payments or transfers to freight rebate funds.

(ii) A net revenue account starting with the balance as shown by the statement of revenue receipts and expenditure referred to in (i) above and showing separately any charges for income-tax and profits tax, provision for redemption of British Transport stock, payments to local authorities in respect of the redemption of loans outstanding in connection with undertakings transferred to the Commission, administration expenses incurred prior to 1st January, 1948, compensation payable to staff under any regulations made under Section 101 of the Transport Act, 1947, transfers to or from general reserve and other special charges and appropriations.

- (c) The consolidated balance sheet shall show the consolidated financial position as at the 31st December of the Commission, including the executives and any departments of the Commission and, so far as practicable and appropriate, any subsidiary companies. Fixed and current assets, investments, capital and current liabilities, British Transport stock redemption fund accounts and investments, provision for depreciation and other major provisions shall be classified under appropriate headings and any amounts transferred to or from the general reserve during the year shall be shown separately.
- (d) The Commission shall provide, where appropriate, notes in explanation of items in the accounts and shall also attach, where appropriate, supplementary schedules.

In particular the Commission shall furnish:

- (i) Analyses of the working results of each principal activity as follows:
 British Railways;
 Collection and delivery and other road haulage services;
 Road haulage: British Road Services;
 Road passenger services: Provincial and Scottish groups;
 London Transport Road Passenger Services;
 London Transport Railways;
 Ships and vessels;
 Inland waterways: carrying operations;
 Docks, harbours and wharves;
 Inland waterways: other than carrying operations;
 Hotels and catering;
 Commercial advertising;
 Letting of sites, shops, &c., on premises and properties in use for transport purposes;
 Generation and distribution of electric current.
- (ii) Summary of central administration expenses of the Commission;
- (iii) Analyses of fixed assets by main types and principal activities, showing the movements in each main category of asset during the year;
- (iv) Analyses of depreciation provisions under each main category of asset, showing the movements during the year;
- (v) Summaries of movements during the year on reserve accounts and major provisions;
- (vi) Abstracts of accounts relating to every class of British Transport stock, showing the amounts issued and cancelled during the year and the balance of stock outstanding at the end of the year, and of the redemption fund accounts in respect thereof, showing the provisions for redemption made during the year and the balance standing to the credit of each account at the end of the year.
- (e) The Commission shall also provide a summary showing the amounts of their borrowing powers and the extent to which they have been used.
- (f) For purposes of comparison, the annual statement of accounts and supplementary schedules for 1949 and subsequent years shall show, so far as is practicable, corresponding figures for the preceding year.
- (g) Amounts shall be shown to the nearest pound.

Signed by authority of the Minister of Transport this twenty-seventh day of July, 1949.

T. G. JENKINS,
Secretary, Ministry of Transport.

TRANSPORT ACT, 1947

SCHEME OF AUDIT OF THE ACCOUNTS OF THE BRITISH TRANSPORT COMMISSION APPROVED BY THE MINISTER OF TRANSPORT

The Minister of Transport in exercise of the powers conferred upon him by Section 94 of the Transport Act, 1947, and of all other powers him enabling, hereby approves the following scheme of audit:

1. In this scheme, unless the context otherwise requires, the following expressions have the meanings hereby respectively assigned to them:

'the Act' means the Transport Act, 1947;

'the auditors' means the auditor or auditors for the time being of the accounts of the Commission, appointed by the Minister under subsection (3) of Section 94 of the Act;

'the Commission' means the British Transport Commission;

'Executive' means an executive established by or under Section 5 of the Act,

'financial year' means a year ending with the 31st December of that year;

'The Minister' means the Minister of Transport.

2. The auditors shall examine the books, accounts and records of the Commission and shall report:

- (a) whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit;
- (b) whether in their opinion proper books of account and other records in relation thereto have been kept by the Commission so far as appears from their examination of those books and records, and whether proper returns adequate for the purposes of their audit have been received from every executive and department of the Commission, whose accounts have been examined and reported upon by such auditors or firms of auditors appointed by the Commission as are referred to in paragraph 3 of this scheme; and
- (c) (i) whether the balance sheet and revenue account for the financial year, and any other account required to be included in the Commission's annual statement of accounts for that year are in agreement with the said books of account and records and with the returns examined and reported upon as aforesaid; and
(ii) whether in their opinion and to the best of their information and according to the explanations given to them the said balance sheet gives a true and fair view of the state of the Commission's affairs at the end of the financial year and the said revenue account gives a true and fair view of the operating results and the profit or loss for the said year, and any other such account gives a true and fair view of the matters to which it relates.

3. The Commission having expressed their intention of appointing so far as is practicable professional auditors or firms of auditors to audit on their behalf the books and records of the executives and departments of the Commission, the auditors are authorised, to the extent which is in their judgment reasonable, to rely for the purposes of their audit upon the audits carried out by any auditors or firms of auditors appointed by the Commission to carry out such audits, provided that:

- (a) the auditors approve the general lines of the work carried out by any such auditor or firm of auditors;
- (b) the auditors are furnished by any such auditor or firm of auditors with answers to such enquiries and with such further information and explanations as they may require; and
- (c) the Commission comply with the provisions of paragraph 4 of this scheme.

4. The Commission shall maintain proper systems of internal check and after consultation with the auditors shall take steps to ensure the integration of the programmes of professional audit and the provision of such liaison as may be necessary between the auditors and such other auditors or firms of auditors appointed by the Commission as are referred to in paragraph 3 of this scheme.

5. This scheme may be revoked or varied by any later scheme approved by the Minister—

- (a) as respects any financial year commencing on or after 1st January next following the date upon which the later scheme is so approved;
- (b) as respects any financial year commencing on or after the 1st January next preceding the date upon which the later scheme is so approved if that scheme is so approved not later than the 1st February in that year; or
- (c) if in exercise of his powers under subsection (3) of Section 94 of the Act,

the Minister directs that the accounts of the Commission as respects any part of their undertaking specified in the direction shall be separately audited.

Given under the official seal of the Minister of Transport this 1st day of July, 1948.

(Signed) ALFRED BARNES,
The Minister of Transport.

COAL INDUSTRY NATIONALISATION ACT, 1946

DIRECTIONS ISSUED BY THE MINISTER OF FUEL AND POWER

Ministry of Fuel and Power,
London, S.W.1.
23rd June, 1948.

My Lord,

1. In pursuance of Section 31 of the Coal Industry Nationalisation Act, 1946, the Minister of Fuel and Power issues the following directions to the National Coal Board.

2. The statement of accounts prepared by the National Coal Board in respect of the financial year of the Board which ended on 31st December, 1946, shall be in a form comprising the balance sheet and statement specified in the First Schedule to this letter and complying with the requirements so specified.

3. The statement of accounts prepared by the Board in respect of any other financial year shall be in a form comprising the balance sheet, profit and loss account and separate statements specified in the Second Schedule to this letter and complying with the requirements so specified. Reference in that Schedule to 'main activity' means any of the activities specified in the Third Schedule to this letter.

4. Where in any account, statement or summary the figures respectively applicable to each Division of the Board are required to be shown, a figure shall also be included therein applicable to the headquarters of the Board and to any activity of the Board not included in the relevant figure for any such Division.

5. Where any total sum includes a fraction of a pound expressed in shillings or pence that fraction shall, if it exceeds ten shillings, be treated as one pound, and in any other case be disregarded.

I am, My Lord,

The Chairman,
National Coal Board.

Your obedient Servant,
(Signed) DONALD FERGUSSON.

FIRST SCHEDULE

1. Balance sheet

Fixed and current assets, investments, capital and current liabilities, provisions and reserves shall be classified under appropriate headings; so however that advances by the Minister under Section 26 of the Act shall be separately shown. The balance sheet shall state how the amounts of fixed assets have been arrived at and shall show separately the amounts of provision for depreciation.

2. Statement of expenditure on revenue account for the period from 15th July to 31st December, 1946

The aggregate amount paid to members of the Board shall be separately shown.

SECOND SCHEDULE

1. Balance sheet

Fixed and current assets, investments, capital and current liabilities, provisions and reserves shall be classified under appropriate headings; so however that advances by the Minister under Section 26 of the Act, liability for compensation under the Act and the value of fixed assets vesting in the Board under the Act shall be separately shown.

2. *Profit and loss account*

The net amount of operating profit or loss, the other main items of income and expenditure and the interest and interim income payable to the Minister shall be shown.

3. *Fixed assets: summary*

- (1) This shall show how the amounts of the fixed assets shown in the balance sheet have been arrived at and shall distinguish between:
 - (a) assets vested under the Act;
 - (b) assets otherwise acquired;
 - (c) assets disposed of.
- (2) The amounts shown under (b) and (c) shall be subdivided to show separately:
 - (i) the Division concerned;
 - (ii) the activities for which the assets are respectively used.
- (3) The differences between the amounts respectively shown under (b) and (c) shall be analysed according to the type of asset.

4. *Analysis of depreciation provision for fixed assets*

Separate amounts shall be shown for:

- (1) the Division concerned;
- (2) the activities for which the assets are respectively used.

5. *Schedule of stocks*

The values for each Division shall be shown of:

- (1) stocks of products (separate figures to be given for each main type);
- (2) stores and materials.

6. *Debtors and bills receivable: summary for each Division*

Separate amounts shall be shown for:

- (1) loans to members of the Board, officials and staffs;
- (2) amount of the provision for bad and doubtful debts and for discounts and allowances.

7. *Capital liabilities: summary*

There shall be shown in respect of each separate item:

- (1) the amount borrowed;
- (2) the amount repaid;
- (3) the amount outstanding.

8. *Provision for deferred liabilities: summary for each division*

Liabilities shall be grouped under appropriate headings.

9. *Current liabilities: summary for each division*

- (1) Liabilities shall be grouped under appropriate headings.
- (2) Interim income shall be treated as a separate group.

10. *Statement of the reserve fund*

- (1) The amounts received from the Coal Commission and any other amounts transferred to or from the fund during the year shall be shown separately.
- (2) Particulars of investment as at the end of the year shall be included.

11. *Operating profits and losses: summary for each division*

The amount of profit or loss on each main activity shall be shown.

12. *Table of divisional or area colliery profit and loss accounts*

The saleable tonnage, proceeds, costs (analysed under appropriate headings) and net profit or loss shall be shown.

13. *Table of divisional coke oven profit and loss accounts*

The tonnage of coke produced, the proceeds, costs (analysed under appropriate headings) and net profit or loss shall be shown.

14. *Table of analyses of income and expenditure of each division on revenue account*

The amounts paid to members of the Board and the amounts of the administrative expenses of the national and divisional headquarters shall be shown.

15. *Winding up of the Coal Commission: account of transactions*

This shall be prepared in accordance with the requirements of the Coal Commission (Dissolution) Order, 1947, S.R. & O. No. 396.

THIRD SCHEDULE

Coal selling depots;
Coke ovens;
Secondary by-product plants;
Manufactured fuel plants;
Briquetting plants;
Brickworks and tileworks;
Railway wagons;
Wagon repair shops;
Houses;
Estates and farms;
Colliery activities not herein specifically mentioned.

MUNICIPAL ACCOUNTS

LOCAL GOVERNMENT ACT, 1933

23 & 24 Geo. 4, Ch. 51

GENERAL

Accountability of officers

120.—(1) Every officer employed by a local authority, whether under this Act or any other enactment, shall at such times during the continuance of his office, or within three months after his ceasing to hold it, and in such manner, as the local authority direct, make out and deliver to the authority, or as they direct, a true account in writing of all money and property committed to his charge, and of his receipts and payments, with vouchers and other documents and records supporting the entries therein, and a list of persons from whom or to whom money is due in connection with his office, showing the amount due from or to each.

(2) Every such officer shall pay all money due from him to the treasurer of the county, borough, district or parish, as the case may be, or otherwise as the local authority may direct.

(3) If any such officer—

(a) refuses or wilfully neglects to make any payment which he is required by this section to make; or

(b) after three days' notice in writing, signed by the clerk of the authority or by three members thereof, and given or left at his usual or last known place of residence, refuses or wilfully neglects to make out or deliver to the authority, or as they direct, any account or list which he is required by this section to make out and deliver, or any voucher or other document or record relating thereto, or to give satisfaction respecting it to the authority or as they direct;

a court of summary jurisdiction having jurisdiction where the officer is or resides may, on complaint, by order require him to make such payment or delivery or to give such satisfaction.

(4) Nothing in this section shall affect any remedy by action against any such officer or his surety, except that the officer shall not be both sued by action and proceeded against summarily for the same cause.

Disposal of land

164. A local authority may let any land which they may possess—

(a) with the consent of the Minister, for any term;

(b) without the consent of the Minister, for a term not exceeding seven years.

165. A local authority may, with the consent of the Minister—

- (a) sell any land which they may possess and which is not required for the purpose for which it was acquired or is being used; or
- (b) exchange any land which they may possess for other land, either with or without paying or receiving any money for equality of exchange.

166.—(1) Capital money received by a local authority in respect of a transaction under either of the two last preceding sections shall be applied in such manner as the Minister may approve towards the discharge of any debt of the local authority or otherwise for any purpose for which capital money may properly be applied:

Provided that, where any land to which the transaction relates is parish property vested in the council of a borough or urban or rural district on behalf of a parish situate in the borough or district, any capital money received by the council in respect of the transaction shall be applied in such manner as the Minister may approve towards the discharge of any debt of the parish or otherwise for the permanent advantage of the parish.

(2) Where capital money is applied under this section for a purpose other than that for which the land which was the subject of the transaction was held, such adjustment shall be made in the accounts of the local authority as the Minister may direct.

COUNTY COUNCILS

181.—(1) All receipts of a county council, whether for general or special county purposes, shall be carried to the county fund, and all liabilities falling to be discharged by the council, whether for general or special county purposes, shall be discharged out of that fund.

(2) Separate accounts shall be kept of receipts carried to, and payments made out of, the county fund—

- (a) for general county purposes;
- (b) for each special county purpose, except that, where as respects any two or more special county purposes the part of the county chargeable is the same, one separate account may be kept as respects both or all of those purposes;

and the account for general county purposes shall be called the general county account, and an account for any special county purpose shall be called a special county account.

184.—(1) All payments to and out of the county fund shall be made to and by the county treasurer.

(2) All payments out of the county fund shall, unless made in pursuance of the specific requirement of any enactment, or of an order of a competent court, or of a justice of the peace acting in discharge of his judicial functions, be made in pursuance of an order of the county council signed by three members of the finance committee thereof present at the meeting of the council at which the order is made, and countersigned by the clerk of the council, and the same order may include several payments.

(3) An order for the payment of a sum out of the county fund shall not be made by a county council except in pursuance of a resolution of the council passed on the recommendation of the finance committee.

(4) All cheques for payment of moneys issued in pursuance of an order of a county council made under this section shall be countersigned by the clerk of the county council or by some other person approved by the council.

(5) Any person aggrieved by an order of a county council made under this section may appeal to the High Court, and on any such appeal the High Court may give such directions in the matter as they think proper, and the order of the High Court shall be final.

BOROUGH COUNCILS

185.—(1) All receipts of the council of a borough, including the rents and profits of all corporate land, shall be carried to the general rate fund of the borough, and all liabilities falling to be discharged by the council shall be discharged out of that fund.

(2) An account, called the 'general rate fund account', shall be kept of all receipts carried to, and payments made out of, the general rate fund:

Provided that, where any such receipts are receipts for the benefit of a part only of the borough, or any such payments are payments in respect of expenditure with which a part only of the borough is chargeable, a separate account shall be kept of receipts and payments in respect of that part of the borough.

(3) If the general rate fund is more than sufficient for the purposes to which it is applicable, the surplus thereof may be applied under the direction of the council for the public benefit of the inhabitants and improvement of the borough.

Power of borough council to levy rates

186. The council of a borough shall have power to levy rates to meet all liabilities falling to be discharged by the council for which provision is not otherwise made.

Payments to and out of general rate fund of borough

187.—(1) All payments to and out of the general rate fund of a borough shall be made to and by the treasurer.

(2) Except as otherwise expressly provided in this section, all payments out of the general rate fund shall be made in pursuance of an order of the council signed by three members thereof and countersigned by the town clerk, and the same order may include several payments:

Provided that the following payments may be made out of the general rate fund without an order of the council, that is to say, payments made—

- (a) in pursuance of the specific requirement of any enactment;
 - (b) in pursuance of an order of a competent court or of a justice of the peace acting in discharge of his judicial functions;
 - (c) in respect of any remuneration of—
 - (i) the mayor;
 - (ii) the recorder in his capacity either of recorder or of judge of the borough civil court;
 - (iii) the stipendiary magistrate;
 - (iv) the clerk of the peace, when paid by salary;
 - (v) the clerk of the borough justices;
 - (vi) any other officer or person whose remuneration is payable by the council;
 - (d) in respect of the remuneration and allowances certified by the Treasury to be payable to the Treasury in relation to an election petition;
 - (e) in respect of the remuneration certified by the recorder to be due to an assistant recorder, assistant clerk of the peace, or additional crier.
- (3) Any person aggrieved by an order of the council made under this section may appeal to the High Court, and on any such appeal the High Court may give such directions in the matter as they think proper, and the order of the High Court shall be final.

URBAN DISTRICT COUNCILS

188.—(1) All receipts of the council of an urban district shall be carried to the general rate fund of the district, and all liabilities falling to be discharged by the council shall be discharged out of that fund.

(2) An account, called the 'general rate fund account', shall be kept of all receipts carried to, and payments out of, the general rate fund:

Provided that, where any such receipts are receipts for the benefit of a part only of the district, or any such payments are payments in respect of expenditure with which a part only of the district is chargeable, a separate account shall be kept of receipts and payments in respect of that part of the district.

189. The council of an urban district shall have power to levy rates to meet all liabilities falling to be discharged by the council for which provision is not otherwise made.

RURAL DISTRICT COUNCILS

190.—(1) The expenses incurred by a rural district council in the discharge of their functions shall be divided into general expenses and special expenses.

(2) All expenses incurred by a rural district council not declared by or under this Act or any other enactment or statutory order to be special expenses shall be general expenses.

(3) The Minister may, by order, on the application of a rural district council, declare any expenses incurred by that council, whether before or after the commencement of this Act, to be special expenses separately chargeable on such contributory place or places in the district as may be specified in the order, and, if the said expenses are declared to be chargeable on more than one contributory place, the order may apportion the expenses amongst the contributory places:

Provided that, where any expenses are declared under this subsection to be special expenses separately chargeable on any part of a rural district, the Minister may nevertheless direct that those expenses shall be levied in that part of the district together with, and as an additional item of, the general rate and not by a special rate.

(4) Where any expenses of a rural district council, whether incurred before or after the commencement of this Act, are payable as special expenses, the council may determine to contribute as part of their general expenses such sums as appear to them to be reasonable in or towards defraying such expenses, and to treat the remainder, if any, as special expenses.

(5) Where any special expenses have been incurred, whether before or after the commencement of this Act, for the common benefit of any two or more contributory places, the rural district council may, subject to the apportionment, if any, contained in an order made under subsection (3) of this section, apportion the expenses in such proportions as they think just between those contributory places, and any expenses so apportioned to any contributory place shall be a separate charge on that contributory place.

191.—(1) All receipts of the council of a rural district, whether in respect of general or special expenses, shall be carried to the general rate fund of the district, and all liabilities falling to be discharged by the council, whether in respect of general or special expenses, shall be discharged out of that fund.

(2) Separate accounts shall be kept of receipts carried to, and payments made out of, the general rate fund of the district—

(a) in respect of general expenses;

(b) in respect of each class of special expenses, except that where, as respects any two or more classes of special expenses, the part of the district chargeable is the same, one separate account may be kept as respects all expenses of both or all those classes;

and the account kept in respect of general expenses shall be called the general district account and an account kept in respect of any class of special expenses shall be called a special district account.

192.—(1) The council of a rural district shall have power to levy rates to meet all liabilities falling to be discharged by the council for which provision is not otherwise made.

(2) Amounts leviable by a rural district council by means of a rate shall be chargeable—

(a) in the case of amounts leviable to meet liabilities in respect of general expenses, on the whole of the district; and

(b) in the case of amounts leviable to meet liabilities in respect of special expenses, on the part of the district chargeable separately therewith.

PARISH COUNCILS AND PARISH MEETINGS

193.—(1) The sums required to be raised to meet the expenses of a parish council or of a parish meeting (including the expenses of a poll consequent on a parish meeting) shall be chargeable separately on the parish.

(2) In a parish having a separate parish council the expenses of the parish meeting (including the expenses of any poll consequent on a parish meeting) shall be paid by the parish council.

(3) The sums required to be raised in any financial year to meet the expenses of a parish council (other than expenses under the adoptive Acts*) shall not, without the consent of the parish meeting, exceed an amount equal to a rate of fourpence in the pound, calculated on the total rateable value as set out in the valuation list in force at the commencement of the financial year, or such higher rate as the Minister may by order as respects any particular parish allow, and shall in no case exceed an amount equal to a rate of eightpence in the pound, calculated as aforesaid, or such higher rate as the Minister may by order as respects any particular parish allow.

(4) A parish council shall not, without the consent of the parish meeting and the approval of the county council, incur any expense or liability which will involve a loan.

(5) In a parish not having a parish council, the sums required to be raised in any financial year to meet the expenses of the parish meeting when added to the expenses of any authority under any of the adoptive Acts shall not exceed an amount equal to a rate of eightpence in the pound, calculated as aforesaid, or such higher rate as the Minister may by order as respects any particular parish allow.

(6) For the purpose of obtaining sums necessary to meet the expenses of a parish council or of a parish meeting, the parish council, or the chairman of the parish meeting of a parish not having a separate parish council, shall issue precepts to the council of the rural district in which the parish is situate.

(7) Any such precept may be enforced under and in accordance with the provisions of the Poor Rate Act, 1839, or of Section 13 of the Rating and Valuation Act, 1925.

(8) Every cheque or other order for the payment of money by a parish council shall be signed by two members of the council.

(9) Every parish council and the chairman of the parish meeting for a rural parish not having a separate parish council shall keep such accounts as may be prescribed of the receipts and payments of the council or parish meeting, as the case may be.

(10) An order made by the Minister under this section may be altered or revoked by an order made in like manner as the original order.

(11) Nothing in this section shall alter the incidence of charge of any rate levied to defray expenses incurred under any of the adoptive Acts.

Sinking fund

213.—(1) If a local authority determine to repay by means of a sinking fund any sums borrowed under this Part of this Act by way of mortgage, the sinking fund shall be formed and maintained either—

- (a) by payment to the fund throughout the fixed period of such equal annual sums as will be sufficient to pay off within that period the moneys for the repayment of which the sinking fund is formed; or
- (b) by payment to the fund throughout the fixed period of such equal annual sums as, with accumulations at a rate not exceeding the prescribed rate, or such other rate as the Minister may in any particular case approve, will be sufficient to pay off within that period the moneys for the repayment of which the sinking fund is formed.

In this Part of this Act a sinking fund formed under paragraph (a) of this subsection is referred to as 'a non-accumulating sinking fund', and a sinking fund formed under paragraph (b) thereof as 'an accumulating sinking fund'.

(2) Every sum paid to a sinking fund shall, unless applied in repayment of the moneys for the repayment of which the sinking fund is formed, or in such other manner as may be authorised by any enactment, be immediately invested in statutory securities (other than securities created by the local authority), and the local authority may from time to time vary and transpose the investments.

(3) In the case of an accumulating sinking fund, the interest received in any year from the investment of the sums set apart for the purposes of the sinking fund shall form part of the revenue for that year of the county fund or general rate fund, as the case may be, but the contribution to be made to the sinking fund out of the county fund or general rate fund, as the case may be, shall in

* Or under Part VI of the Local Government Act, 1948 (Section 114 (5)).

that year be increased by a sum equal to the interest that would have accrued to the sinking fund during that year if interest had been accumulated therein at the rate per cent. per annum on which the annual payments to the sinking fund are based.

(4) A local authority may at any time apply the whole or any part of a sinking fund in or towards the discharge of the moneys for the repayment of which the sinking fund was formed:

Provided that, in the case of an accumulating sinking fund, the local authority shall pay into the fund each year and accumulate during the residue of the fixed period a sum equal to the interest which would have been produced by such sinking fund or part thereof so applied if invested at the rate per cent. per annum on which the annual payments to the sinking fund are based.

(5) Any surplus of a sinking fund remaining after the discharge of the whole of the moneys for the repayment of which it was formed shall be applied to such capital purpose as the local authority, with the consent of the Minister, may determine.

(6) Subsection (2) of this section shall apply to a sinking fund established by a local authority under any enactment for the repayment of moneys borrowed by way of mortgage, and subsections (3), (4) and (5) of this section shall apply to an accumulating sinking fund so established, in like manner as they respectively apply to a sinking fund or an accumulating sinking fund established under this Part of this Act.

(7) In the application of this section to a sinking fund formed by a parish council, references to the county fund or general rate fund shall be read as references to the fund out of which the expenses of the council are defrayed.

214.—(1) If at any time it appears to the local authority that the amount in a sinking fund, together with the sums which will be payable thereto in accordance with the provisions of this Part of this Act, and, in the case of an accumulating sinking fund, with the accumulations thereon, will not be sufficient to repay within the fixed period the moneys for the repayment of which the sinking fund is formed, the local authority shall, either temporarily or permanently, make such increased payments to the sinking fund as will cause the sinking fund to be sufficient for that purpose, and if it appears to the Minister that any such increase is necessary, the local authority shall increase the payments to such extent as the Minister may direct.

(2) If the local authority desire to accelerate the repayment of any moneys borrowed by way of mortgage, they may increase the amounts payable to the sinking fund.

(3) If the amount in a sinking fund, together with the sums which will be payable thereto in accordance with the provisions of this Part of this Act, and also, in the case of an accumulating sinking fund, together with the accumulations thereon, will in the opinion of the Minister be more than sufficient to repay within the fixed period the moneys for the repayment of which the sinking fund is formed, the local authority may reduce the payments to the sinking fund either temporarily or permanently to such amounts as will in the opinion of the Minister be sufficient to repay within the fixed period the moneys for the repayment of which the sinking fund is formed.

(4) If at any time the amount in a sinking fund, together with the accumulations thereon in the case of an accumulating sinking fund, will in the opinion of the Minister be sufficient to repay the moneys for the repayment of which the sinking fund is formed within the fixed period, the Minister may authorise the local authority to suspend the annual payments to the sinking fund until the Minister otherwise directs.

(5) This section shall apply to a sinking fund established by a local authority under any other enactment for the repayment of moneys borrowed by way of mortgage in like manner as it applies to a sinking fund established under this Part of this Act.

PART X ACCOUNTS AND AUDIT

Accounts subject to district audit and appointment and expenses of district auditors

219. The following accounts shall be subject to audit by a district auditor under this Part of this Act, that is to say—

- (a) the accounts of every county council, metropolitan borough council, urban district council, rural district council and parish council, and of every parish meeting for a rural parish not having a parish council;
- (b) the accounts of any committee appointed by any such council or parish meeting;
- (c) the accounts of any joint committee constituted under Part III of this Act or under any enactment repealed by this Act, of which one or more of the constituent authorities are a county or metropolitan borough or district or parish council or the council of a borough all of whose accounts are subject to audit by a district auditor;
- (d) any other accounts which are made subject to audit by a district auditor by virtue of any enactment or statutory order or, in the case of the accounts of the council of a borough, by virtue of a resolution adopting the system of district audit passed by the council in accordance with the provisions of this Part of this Act:

Provided that in relation to any audit of accounts under paragraph (d) of this section this Part of this Act shall have effect subject to the provisions of the relevant enactment or statutory order.

220.—(1) The Minister may, with the consent of the Treasury, appoint such number of district auditors as he thinks necessary for the performance of the duty of auditing the accounts which are for the time being by law subject to audit by district auditors, and may remove any auditor.

(2) The Minister may assign to district auditors their duties, and the districts in which they are respectively to act, and may change wholly or in part such duties or districts, and every district so assigned to a district auditor, whether originally or upon any change, shall be deemed to be an audit district, and the auditor to whom any district is assigned shall be deemed to be the district auditor for that district.

(3) The Minister may, with the consent of the Treasury, appoint either temporarily or otherwise, assistant district auditors and other persons to assist district auditors in the performance of their duties, and any person so appointed shall have such of the functions of a district auditor as by the terms of his appointment the Minister may confer on him, and in the discharge of any functions so conferred shall be subject to the same obligations as the district auditor whom he is appointed to assist, and accordingly a reference in this Act to a district auditor shall, in relation to functions discharged by a person appointed under this subsection, include a reference to that person:

Provided that the powers of allowance, disallowance and surcharge shall not be conferred on any person appointed under this subsection not being an assistant district auditor.

(4) The Minister may, with the consent of the Treasury, assign to a person appointed to assist a district auditor such remuneration and such sum for his expenses as may seem fit.

Other financial provisions

221.—(1) The remuneration and expenses of district auditors, including the remuneration and expenses of persons appointed to assist district auditors, to such amount as may be sanctioned by the Treasury, shall be paid out of moneys provided by Parliament.

(2) For the purpose of contributing to the amount required for the payment of the remuneration and expenses aforesaid and the superannuation allowances of district auditors and of persons appointed to assist district auditors, there shall be charged on every authority whose accounts are subject to audit by a district auditor a stamp duty according to such scale as may be fixed from time to time by the Treasury, after consultation with the Minister and with such associations of local authorities as appear to the Minister to be concerned, and the scale so fixed shall be such as to secure that the duties levied under this section shall be sufficient to meet the costs incurred in respect of the remuneration, expenses and superannuation allowances aforesaid:

Provided that the Treasury may, on the application of any authority, and after consultation with the Minister, direct that the stamp duty charged under this section in the case of that authority, shall, instead of being an amount

calculated according to the scale to be fixed under this section, be such an amount, not exceeding the amount chargeable under the scale, as the Treasury think fit having regard to the cost of the audit of the accounts of that authority.

(3) The duties charged under this Part of this Act may, if the Commissioners of Inland Revenue so direct, be denoted by adhesive stamps.

222.—(1) Where any accounts of an authority are audited by a district auditor, the authority shall prepare and submit to the district auditor at every audit a financial statement of those accounts, in duplicate, in the prescribed form and containing the prescribed particulars.

(2) The district auditor, at the conclusion of the audit, shall certify on each copy of the financial statement, in the prescribed form, the amount of the expenditure so audited and allowed, and further, that the regulations with respect to the statement have been duly complied with, and that he has ascertained by the audit the correctness of the statement.

(3) One copy of the financial statement shall have the stamp charged under this Part of this Act affixed thereon, and at the conclusion of the audit the district auditor shall cancel the stamp.

(4) The district auditor shall, immediately after the conclusion of the audit, send the stamped copy of the financial statement to the Minister.

(5) If an authority fail to comply with the provisions of this section with respect to a financial statement, the authority, and if a clerk of the authority is appointed, the clerk, or if no clerk is appointed but there is a treasurer or other officer whose duty it is to keep the accounts which ought to be comprised in the financial statement, the treasurer or other officer shall be liable, on summary conviction, to a fine not exceeding twenty pounds, and notwithstanding the recovery of any such fine, compliance with the provisions of this section may be enforced, at the instance of the Minister, by mandamus.

Procedure as to district audit

223. All accounts which are subject to audit by a district auditor shall be made up yearly to the thirty-first day of March, or to such other date as the Minister may either generally or in any special case direct, and shall be audited as soon as may be thereafter.

224.—(1) A copy of every account which is subject to audit by a district auditor, duly made up and balanced, and all rate books, account books, deeds, contracts, accounts, vouchers and receipts relating to the accounts, shall be deposited in the appropriate office of the authority, and shall for seven clear days before the audit be open at all reasonable hours to the inspection of all persons interested, and any such person shall be at liberty to make copies of or extracts from the deposited documents, without payment.

(2) If any officer of the authority duly appointed in that behalf neglects to make up the aforesaid accounts and books, or, except with the consent of, or in accordance with directions given by, the district auditor, alters, or allows to be altered, the aforesaid accounts and books when so made up and deposited, or having the custody of such accounts and books refuses to allow inspection thereof, he shall be liable on summary conviction to a fine not exceeding five pounds.

(3) Before each audit the authority, on receiving from the auditor the requisite appointment, shall, by advertisement in one or more local newspapers circulating in the district, give at least fourteen days' notice of the deposit of accounts required by this section, and the production of the newspaper containing such notice shall be sufficient proof of such notice in any legal proceeding:

Provided that in the case of the audit of the accounts of a parish council or of a parish meeting or of a joint committee of parish councils, the authority shall, in lieu of giving notice by advertisement, give at least fourteen days' public notice of the deposit of the accounts.

225.—(1) A district auditor may by writing under his hand require the production before him of all books, deeds, contracts, accounts, vouchers, receipts and other documents which he may deem necessary for the purpose of the audit, and may require any person holding or accountable for any such document to appear before him at the audit or any adjournment thereof, and may require

any such person to make and sign a declaration as to the correctness of the document.

(2) If any person neglects or refuses to comply with any such requirement, he shall be liable on summary conviction to a fine not exceeding forty shillings, and if any person knowingly and wilfully makes or signs any such declaration which is untrue in any material particular, he shall be deemed to be guilty of an offence under Section 5 of the Perjury Act, 1911.

226.—(1) A local government elector for the area to the accounts of which the audit relates may be present or may be represented at the audit and may make any objection to the accounts before the auditor.

(2) The district auditor shall, on the application of any person who is aggrieved by his decision on any matter with respect to which that person has made an objection, or of any person aggrieved by a disallowance or surcharge made by the auditor, state in writing the reasons for his decision.

227. Within fourteen days after the completion of the audit of the accounts of an authority the auditor shall report on the accounts audited and examined, and shall send the report to the authority, and the authority shall take the report into consideration at their next ordinary meeting or as soon as practicable thereafter:

Provided that in the case of a parish council or parish meeting or of any joint committee appointed by parish councils or parish meetings the report shall, in lieu of being sent to the authority, be sent to the Minister.

Surcharge, appeals and recovery of sums surcharged

228.—(1) It shall be the duty of the district auditor at every audit held by him—

- (a) to disallow every item of account which is contrary to law;
- (b) to surcharge the amount of any expenditure disallowed upon the person responsible for incurring or authorising the expenditure;
- (c) to surcharge any sum which has not been duly brought into account upon the person by whom that sum ought to have been brought into account;
- (d) to surcharge the amount of any loss or deficiency upon any person by whose negligence or misconduct the loss or deficiency has been incurred;
- (e) to certify the amount due from any person upon whom he has made a surcharge;
- (f) to certify at the conclusion of the audit his allowance of the accounts; subject to any disallowances or surcharges which he may have made:

Provided that no expenses paid by an authority shall be disallowed by the auditor, if they have been sanctioned by the Minister.

(2) Any loss represented by a charge for interest or any loss of interest shall be deemed to be a loss within the meaning of this section, if it arises from failure through wilful neglect or wilful default to make or collect such rates or to issue such precepts as are necessary to cover the expenditure of the authority for any financial year (including any expenditure incurred in any previous year and not covered by rates previously levied or precepts previously issued), or to collect other revenues.

229.—(1) Any person who is aggrieved by a decision of a district auditor on any matter with respect to which he made an objection at the audit, and any person aggrieved by a disallowance or surcharge made by a district auditor may, where the disallowance or surcharge or other decision relates to an amount exceeding five hundred pounds, appeal to the High Court, and may in any other case appeal either to the High Court or to the Minister.

(2) The Court or Minister on such an appeal shall have power to confirm, vary or quash the decision of the auditor, and to remit the case to the auditor with such directions as the Court or Minister thinks fit for giving effect to the decision on appeal, and if the decision of the auditor is quashed, or is varied so as to reduce the amount of the surcharge to five hundred pounds or less, the appellant shall not be subject to the disqualification by reason of the surcharge imposed by Part II of this Act, or by the corresponding provision of any enactment relating to London.

(3) Where an appeal is made to the Minister under this section, he may at any stage of the proceedings, and shall, if so directed by the High Court, state

in the form of a special case for the opinion of the Court any question of law arising in the course of the appeal, but save as aforesaid the decision of the Minister shall be final.

230.—(1) In the case of a surcharge, the person surcharged may, whether or not he appeals under the preceding section, apply to the tribunal (whether the High Court or the Minister) to whom he appeals or, if he does not appeal, to the tribunal (whether the High Court or the Minister) to whom he might have appealed, for a declaration that in relation to the subject matter of the surcharge he acted reasonably or in the belief that his action was authorised by law, and the Court or Minister, if satisfied that there is proper ground for doing so, may make a declaration to that effect.

(2) Where such a declaration is made the person surcharged, if by reason of the surcharge he is subject to the disqualification imposed by Part II of this Act, or by the corresponding provision of any enactment relating to London, shall not be subject to that disqualification, and the Court or Minister may, if satisfied that the person surcharged ought fairly to be excused, relieve him either wholly or in part from personal liability in respect of the surcharge, and the decision of the Court or Minister under this section shall be final.

231.—(1) Provision shall be made by rules of court for limiting the time within which appeals and applications may be made to the High Court under this Part of this Act, and for securing that where an application is made public notice of the hearing shall be given, and for enabling any local government elector for the area of the authority whose accounts were subject to the audit to appear at the hearing and object.

(2) Where under this Part of this Act an appeal or application is made to the Minister, the appellant or applicant shall be entitled, if he so desires, to a personal hearing by a person appointed for the purpose by the Minister.

232. Every sum certified by a district auditor to be due from any person shall be paid by that person to the treasurer of the authority within fourteen days after it has been so certified, or, if an appeal or application with respect to that sum has been made, within fourteen days after the appeal or application is finally disposed of or abandoned or fails by reason of the non-prosecution thereof.

233.—(1) Any sum which is certified by a district auditor to be due and has become payable shall, on complaint made or action taken by or under the direction of the district auditor, be recoverable either summarily or otherwise as a civil debt.

(2) In any proceedings for the recovery of such a sum, a certificate signed by a district auditor shall be conclusive evidence of the facts certified, and a certificate signed by the treasurer of the authority concerned or other officer whose duty it is to keep the accounts that the sum certified to be due has not been paid to him shall be conclusive evidence of non-payment, unless it is proved that the sum certified to be due has been paid since the date of the certificate.

Unless the contrary is proved, a certificate purporting to be signed by a district auditor, or by the treasurer of the authority or other officer whose duty it is to keep the accounts, shall be deemed to have been signed by such auditor, treasurer or other officer, as the case may be.

(3) Notwithstanding anything in the Summary Jurisdiction Acts, proceedings before a court of summary jurisdiction to recover sums certified by a district auditor to be due may be commenced at any time before the expiration of nine months from the date of the disallowance or surcharge, or, in the event of an appeal or application being made to the High Court or to the Minister, before the expiration of nine months from the date on which the appeal or application is finally disposed of or abandoned or fails by reason of non-prosecution thereof.

234.—(1) Any expenses incurred by a district auditor in the defence of any allowance, disallowance or surcharge made by him shall, so far as not recovered from any other party and except as may otherwise be ordered by the Court or the Minister, as the case may be, be reimbursed to him out of the fund to which the accounts subject to the audit relate, and the Court or Minister may make such order as may seem fit in regard to the payment out of that fund of the expenses incurred by the appellant or applicant or any other party to the proceedings.

(2) Subject to the approval of the Minister, the expenses incurred by a district

auditor in any legal proceedings taken by him or under his direction shall, so far as not recovered from any other source, be paid out of the fund to which the accounts subject to the audit relate, and any expenses so payable shall include reasonable compensation for loss of time incurred by the district auditor in the proceedings.

Powers of the Minister as to district audit

235.—(1) The Minister may make regulations generally with respect to the preparation and audit of accounts which are subject to audit by a district auditor, including—

- (a) the financial transactions which are to be recorded in the accounts;
- (b) the mode of keeping the accounts of the authority and their officers, and the form of those accounts;
- (c) the mode in which, if it is so prescribed, the accounts are to be certified by the authority or any officer of the authority;
- (d) the publication of the time and place of holding the audit;
- (e) the persons by whom the accounts are to be produced for audit;
- (f) the mode of conducting the audit;
- (g) the form of certificates to be given by district auditors;
- (h) the deposit and inspection of the accounts as audited, and the publication of information with respect thereto;
- (i) the making of an abstract of the accounts as audited.

(2) If any person wilfully neglects or disobeys any regulation made under this section, he shall be liable on summary conviction, for a first offence to a fine not exceeding five pounds, and for a second or subsequent offence to a fine not exceeding twenty pounds.

(3) Regulations made under this section shall be laid before each House of Parliament as soon as may be after they are made.

236.—(1) The Minister may at any time direct a district auditor to hold an extraordinary audit of any accounts which are subject to audit by a district auditor.

(2) An extraordinary audit held under this section shall be deemed to be an audit for the purposes of this Part of this Act, and the provisions of this Part of this Act, other than those requiring the authority to prepare and submit a financial statement of the accounts, to deposit copies of the accounts and documents relating thereto for public inspection and to give notice thereof by advertisement, shall apply accordingly.

(3) An extraordinary audit may be held after three days' notice in writing given to the authority or persons whose accounts are to be audited.

Municipal audit

237.—(1) In every borough there shall, unless and until any such alternative method of audit as hereinafter mentioned is in force at the commencement of this Act or is adopted by the council, be three borough auditors, two elected by the local government electors for the borough, called elective auditors, and one appointed by the mayor, called mayor's auditor.

(2) An elective auditor shall be a person qualified to be a councillor of the borough, but he may not be a member or officer of the council.

(3) The mayor's auditor shall be appointed from among the members of the council.

(4) The term of office of each auditor shall be one year.

(5) The appointment of the mayor's auditor shall be made on the ordinary day of election of elective auditors, and on a casual vacancy occurring the vacancy shall be filled within ten days thereof.

238.—(1) The ordinary day of election of elective auditors shall be the first day of March or such other day as the council of the borough, with the approval of the Minister, may appoint.

(2) An election of elective auditors shall be held at the town hall or some other convenient place appointed by the mayor.

(3) An elector shall not vote for more than one person to be elective auditor.

(4) Save as in this section provided, all the provisions of this Act with respect to the nomination and election of councillors of a borough not divided into wards

shall apply to the nomination and election of elective auditors, and the provisions of this Act with respect to acceptance of office, resignation, filling of casual vacancies and re-election, except the provision with respect to a casual vacancy occurring within six months before the ordinary day of retirement, shall apply to elective auditors as they apply to councillors of a borough.

(5) All expenses properly incurred by the mayor or town clerk in relation to the holding of an election of elective auditors shall be paid by the council of the borough.

239.—(1) The council of a borough may, by means of a resolution passed and confirmed in accordance with the provisions of this section, adopt either—

- (a) the system of district audit; or
- (b) the system of professional audit.

(2) Where the system of district audit is adopted, then as from such date, not being a date earlier than the commencement of the financial year in which the resolution was confirmed, as the Minister may direct, the provisions of Sections 237 and 238 of this Act shall cease to apply in the borough, and the accounts of the council of the borough shall be subject to audit by a district auditor.

(3) Where the system of professional audit is adopted, then as from such date as may be specified in the resolution, the following provisions shall have effect—

- (a) an auditor or auditors shall be appointed in writing under the seal of the corporation for such period and on such terms as to remuneration or otherwise as the council of the borough think fit;
- (b) no person shall be qualified to be so appointed unless he is a member of one or more of the following bodies (namely)—
The Institute of Chartered Accountants in England and Wales;
The Society of Incorporated Accountants and Auditors;
The Society of Accountants in Edinburgh;
The Institute of Accountants and Actuaries in Glasgow;
The Society of Accountants in Aberdeen;
The London Association of Certified Accountants Ltd.;
The Corporation of Accountants Ltd.;
- (c) any auditor so appointed shall be entitled to require from any officer of the borough such books, deeds, contracts, accounts, vouchers, receipts, and other documents, and such information and explanations, as may be necessary for the performance of his duties;
- (d) any auditor so appointed shall include in or annex to any certificate given by him with respect to the accounts audited by him such observations and recommendations (if any) as he thinks necessary or expedient to make with respect to the accounts or any matter arising thereout or in connection therewith;
- (e) Sections 237 and 238 of this Act shall cease to apply in the borough.
- (4) A resolution under this section must be—
- (a) passed by not less than two-thirds of the members of the council voting thereon at a meeting of the council specially convened for the purpose with notice of the object of the meeting, of which not less than one month's previous notice must be given to every member of the council; and
- (b) confirmed by the council at an ordinary meeting held not less than one month after the passing of the resolution.

240. The following provisions shall have effect as respects the accounts of the council of a borough, other than such accounts as are subject to audit by a district auditor—

- (a) the accounts shall be made up yearly to the thirty-first day of March, or to such other date as the council, with the consent of the Minister, may determine;
- (b) as soon as may be after the date to which the accounts are required to be made up, they shall be submitted with the necessary vouchers and papers to, and audited by, the auditor or auditors of those accounts;
- (c) after the audit of the accounts for each financial year the treasurer of the borough shall print an abstract of the accounts for that year;
- (d) in the case of an audit by borough auditors, each of the borough auditors

shall, in respect of each audit of accounts under the Public Health Acts, 1875 to 1932, be paid such reasonable remuneration, not being less than two guineas for every day in which he is employed on the audit, as the council of the borough may determine.

General

241. Where an officer of an authority receives any money or property on behalf of the authority, or receives any money or property for which he ought to account to the authority, the accounts of the officer shall be audited by the auditor of the accounts of the authority, with the same powers, incidents and consequences as in the case of those accounts.

242.—(1) On an application made by the council of a county district to the clerk of the peace of the county in which the county district is wholly or in part situate, the clerk of the peace or his deputy shall examine any bill of costs incurred by the council in respect of legal business performed on their behalf, and the allowance of any sum on such examination shall be *prima facie* evidence of the reasonableness of the amount, but not of the legality of the charge.

(2) The clerk of the peace shall be allowed for every such examination such fees as may be fixed by the master of the Crown Office.

243. This Part of this Act shall extend to London.

PART XI

LOCAL FINANCIAL RETURNS

244.—(1) Subject to the provisions of this section, a return shall be made to the Minister for each year ending on the thirty-first day of March, or on such other day as may be prescribed, of the income and expenditure of every local authority, and of the parish meeting for every rural parish not having a separate parish council.

(2) Subject to the provisions of this section, a return shall be made to the Minister for each year ending on the thirty-first day of March, or on such other day as may be prescribed, of all sums levied or received in respect of the general rate or of any special rate or of any of the following rates, taxes, tolls, or dues, and of the expenditure of any such sums, that is to say—

- (a) any church rate, whether leviable under the common law or the Church Building Acts, 1881 to 1884, or any other enactment;
- (b) any drainage rate or other rate, scot or tax in connection with land drainage, whether leviable under the Land Drainage Act, 1930, or any other enactment or statutory order, or by charter, usage or custom;
- (c) any rate leviable under the Lighting and Watching Act, 1833;
- (d) any tolls or dues leviable under any enactment relating to markets, bridges or harbours;
- (e) any other compulsory rates, taxes, tolls or dues:

Provided that nothing in this subsection shall extend to—

- (i) rates, taxes, tolls or dues levied for the public revenue of the United Kingdom; or
- (ii) tolls or dues taken by any statutory undertakers carrying on business for profit, or by any company within the meaning of the Companies Act, 1929, as revenues of their undertaking; or
- (iii) tolls or dues taken by prescription or otherwise as private property.

(3) The returns required to be made under this section shall—

- (a) be in such form, and contain such particulars, as the Minister may direct;
- (b) be sent to the Minister—

(i) within one month after the completion of the audit of the accounts of the local authority, parish meeting, or other authority or person, as the case may be, for the year in respect of which the return is required to be made; or

(ii) if the audit of those accounts is not completed within six months after the end of the said year, at the expiration of those six months; or

(iii) if the accounts are not required to be audited, within six months after the end of the said year;

- (c) be made—

- (i) in the case of a return relating to the income and expenditure of a local authority, by the clerk of the authority;
 - (ii) in the case of a return relating to the income and expenditure of a parish meeting, by the chairman of the parish meeting;
 - (iii) in the case of a return under subsection (2) of this section, where the power to levy, or to precept for the levying of, the rate, tax, toll, or due, is vested in a corporate body, by their clerk or if there is no clerk by the treasurer or other person whose duty it is to keep the accounts of that body, and in any other case by the person or body of persons in whom that power is vested.
- (4) Where under the preceding subsection a return is required to be made by the clerk of an authority or by the clerk to a corporate body, the return shall be certified by the treasurer or other person whose duty it is to keep the accounts of the authority or corporate body.
- (5) Where any accounts are subject to audit by a district auditor and a copy of the financial statement relating to those accounts is sent to the Minister under Part X of this Act, a return of the income and expenditure comprised in such statement need not, unless the Minister so requires, be sent to the Minister under this Part of this Act, and the copy shall, for the purposes of this Part of this Act, be deemed to be a return made under this Part of this Act.

245. The Minister shall every year cause to be made a summary of the returns sent to him under this Part of this Act, and shall lay it before both Houses of Parliament.

246.—(1) If any person fails to make a return which he is required to make under this Part of this Act, he shall be liable, on summary conviction, to a fine not exceeding twenty pounds, and notwithstanding the recovery of any such fine the making of the return may be enforced, at the instance of the Minister, by mandamus.

(2) Where a return is required to be made under this Part of this Act by a body of persons unincorporate, they shall severally be liable in respect of any failure to make such return.

247. Where under any enactment, whether passed before or after the commencement of this Act, any return relative to any rate, tax, toll or due (other than such as are levied for the public revenue of the United Kingdom) is required to be sent to a Secretary of State or to any other Government department, a duplicate thereof shall in like manner be sent to the Minister, and any person failing to send such duplicate shall be subject to the like penalties as a person failing to make a return under this Part of this Act.

248. This Part of this Act shall extend to London, and accordingly in this Part of this Act the expression 'local authority' includes a metropolitan borough council, and the Common Council of the City of London.

EXECUTORSHIP ACCOUNTS

THE APPORTIONMENT ACT, 1870

33 & 34 *Vict.*, *Ch.* 35

2. From and after the passing of this Act, all rents, annuities, dividends, and other periodical payments in the nature of income (whether reserved or made payable under an instrument in writing or otherwise) shall, like interest on money lent, be considered as accruing from day to day, and shall be apportionable in respect of time accordingly.

5. In the construction of this Act—

· The word 'rents' includes rent service, rent charge, and rent seck, and all tithes and all periodical payments or renderings in lieu of or in the nature of rent or tithe.

The word 'annuities' includes salaries and pensions.

The word 'dividends' includes (besides dividends strictly so called) all payments made by the name of dividend, bonus, or otherwise out of the revenue of trading or other public companies, divisible between all or any of the members of such

respective companies, whether such payments shall be usually made or declared at any fixed times or otherwise; and all such divisible revenue shall, for the purposes of this Act, be deemed to have accrued by equal daily-increment during and within the period for or in respect of which the payment of the same revenue shall be declared or expressed to be made; but the said word 'dividend' does not include payments in the nature of a return or reimbursement of capital.

6. Nothing in this Act contained shall render apportionable any annual sums made payable in policies of assurance of any description.

7. The provisions of this Act shall not extend to any case in which it is or shall be expressly stipulated that no apportionment shall take place.

THE PUBLIC TRUSTEE ACT, 1906

6 *Edw. 7, Ch. 55*

Establishment of public trustee

1.—(1) There shall be established the office of public trustee.

(2) The public trustee shall be a corporation sole under that name, with perpetual succession and an official seal, and may sue and be sued under the above name like any other corporation sole, but any instruments sealed by him shall not, by reason of his using a seal, be rendered liable to a higher stamp duty than if he were an individual.

2.—(1) Subject to and in accordance with the provisions of this Act and rules made thereunder,* the public trustee may, if he thinks fit—

(a) act in the administration of estates of small value;

(b) act as custodian trustee;

(c) act as an ordinary trustee;

(d) be appointed to be a judicial trustee;

(2) Subject to the provisions of this Act, and to the rules made thereunder, the public trustee may act either alone or jointly with any person or body of persons in any capacity to which he may be appointed in pursuance of this Act, and shall have all the same powers, duties and liabilities, and be entitled to the same rights and immunities and be subject to the control and orders of the Court, as a private trustee acting in the same capacity.

(3) The public trustee may decline, either absolutely or except on the prescribed conditions, to accept any trust, but he shall not decline to accept any trust on the ground only of the small value of the trust property.

(4) The public trustee shall not accept any trust which involves the management or carrying on of any business, except in the cases in which he may be authorised to do so by rules made under this Act, nor any trust under a deed of arrangement for the benefit of creditors, nor the administration of any estate known or believed by him to be insolvent.

(5) The public trustee shall not accept any trust exclusively for religious or charitable purposes, and nothing in this Act contained, or in the rules to be made under the powers in this Act contained, shall abridge or affect the powers or duties of the official trustee of charity lands or official trustees of charitable funds.

As custodian trustee

4.—(1) Subject to rules under this Act† the public trustee may, if he consents to act as such, and whether or not the number of trustees has been reduced below the original number, be appointed to be custodian trustee of any trust—

(a) by order of the Court made on the application of any person on whose application the Court may order the appointment of a new trustee; or

(b) by the testator, settlor, or other creator of any trust; or

(c) by the person having power to appoint new trustees.

(2) Where the public trustee is appointed to be custodian trustee of any trust—

(a) the trust property shall be transferred to the custodian trustee as if he

* These rules are the Public Trustee Rules, 1912. (S.R. & O. 1912 No. 348.)

† Certain corporations are now entitled to act as custodian trustees. They are defined in the Public Trustee (Custodian Trustee) Rules, 1925 (S.R. & O. 1925 No. 1269), amending Rule 30 of the Public Trustee Rules, 1912.

were sole trustee, and for that purpose vesting orders may, where necessary, be made under the Trustee Act, 1893;

- (b) the management of the trust property and the exercise of any power of discretion exercisable by the trustees under the trust shall remain vested in the trustees other than the custodian trustee (which trustees are hereinafter referred to as the managing trustees);
- (c) as between the custodian trustee and the managing trustees, and subject and without prejudice to the rights of any other persons, the custodian trustee shall have the custody of all securities and documents of title relating to the trust property, but the managing trustees shall have free access thereto and be entitled to take copies thereof or extracts therefrom;
- (d) the custodian trustee shall concur in and perform all acts necessary to enable the managing trustees to exercise their power of management or any other power or discretion vested in them (including the power to pay money or securities into Court), unless the matter in which he is requested to concur is a breach of trust, or involves a personal liability upon him in respect of calls or otherwise, but, unless he so concurs, the custodian trustee shall not be liable for any act or default on the part of the managing trustees or any of them;
- (e) all sums payable to or out of the income or capital of the trust property shall be paid to or by the custodian trustee: Provided that the custodian trustee may allow the dividends and other income derived from the trust property to be paid to the managing trustees or to such person as they direct, or into such bank to the credit of such person as they may direct, and in such case shall be exonerated from seeing to the application thereof and shall not be answerable for any loss or misapplication thereof;
- (f) the power of appointing new trustees, when exercisable by the trustees, shall be exercisable by the managing trustees alone, but the custodian trustee shall have the same power of applying to the Court for the appointment of a new trustee as any other trustee;
- (g) in determining the number of trustees for the purposes of the Trustee Act, 1893, the custodian trustee shall not be reckoned as a trustee;
- (h) the custodian trustee, if he acts in good faith, shall not be liable for accepting as correct and acting upon the faith of any written statement by the managing trustees as to any birth, death, marriage, or other matter of pedigree or relationship, or other matter of fact, upon which the title to the trust property or any part thereof may depend, nor for acting upon any legal advice obtained by the managing trustees independently of the custodian trustee;
- (i) The Court may, on the application of either the custodian trustee, or any of the managing trustees, or of any beneficiary, and on proof to their satisfaction that it is the general wish of the beneficiaries, or that on other grounds it is expedient, to terminate the custodian trusteeship, make an order for that purpose, and the Court may thereupon make such vesting orders and give such directions as under the circumstances may seem to the Court to be necessary or expedient.
- (3) The provisions of this section shall apply in like manner as to the public trustee to any banking or insurance company or other body corporate entitled by rules made under this Act to act as custodian trustee, with power for such company or body corporate to charge and retain or pay out of the trust property fees not exceeding the fees chargeable by the public trustee as custodian trustee.

An ordinary trustee

5.—(1) The public trustee may by that name, or any other sufficient description, be appointed to be trustee of any will or settlement or other instrument creating a trust or to perform any trust or duty belonging to a class which is authorised by the rules made under this Act to accept, and may be so appointed whether the will or settlement or instrument creating the trust or duty was made or came into operation before or after the passing of this Act, and either as an original or as a new trustee, or as an additional trustee, in the same cases, and in the same manner, and by the same persons or Court, as if he were a private

trustee, with this addition, that, though the trustees originally appointed were two or more, the public trustee may be appointed sole trustee.

(2) Where the public trustee has been appointed a trustee of any trust, a co-trustee may retire from the trust under and in accordance with Section 11 of the Trustee Act, 1893, notwithstanding that there are not more than two trustees, and without such consents as are required by that section.

(3) The public trustee shall not be so appointed either as a new or additional trustee where the will, settlement, or other instrument creating the trust or duty contains a direction to the contrary, unless the Court otherwise order.

(4) Notice of any proposed appointment of the public trustee either as a new or additional trustee shall where practicable be given in the prescribed manner to all persons beneficially interested who are resident in the United Kingdom and whose addresses are known to the persons proposing to make the appointment, or, if such beneficiaries are infants, to their guardians, and if any person to whom such notice has been given within twenty-one days from the receipt of the notice applies to the Court, the Court may, if having regard to the interests of all the beneficiaries it considers it expedient to do so, make an order prohibiting the appointment being made, provided that a failure to give any such notice shall not invalidate any appointment made under this section.

6.—(1) If in pursuance of any rule under this Act, the public trustee is authorised to accept by that name probates of wills or letters of administration, the Court having jurisdiction to grant probate of a will or letters of administration may grant such probate or letters to the public trustee by that name, and for that purpose the Court shall consider the public trustee as in law entitled equally with any other person or class of persons to obtain the grant of letters of administration, save that the consent or citation of the public trustee shall not be required for the grant of letters of administration to any other person, and that, as between the public trustee, the widower, widow, or next of kin of the deceased, the widower, widow, or next of kin shall be preferred, unless for good cause shown to the contrary.

(2) Any executor who has obtained probate or any administrator who has obtained letters of administration, and notwithstanding he has acted in the administration of the deceased's estate, may, with the sanction of the Court, and after such notice to the persons beneficially interested as the Court may direct, transfer such estate to the public trustee for administration either solely or jointly with the continuing executors or administrator, if any. And the order of the Court sanctioning such transfer shall, subject to the provisions of this Act, give to the public trustee all the powers of such executor and administrator, and such executor and administrator shall not be in any way liable in respect of any act or default in reference to such estate subsequent to the date of such order, other than the act or default of himself or of persons other than himself for whose conduct he is in law responsible.

Liability: officers and offices: fees

7.—(1) The Consolidated Fund of the United Kingdom shall be liable to make good all sums required to discharge any liability which the public trustee, if he were a private trustee, would be personally liable to discharge, except where the liability is one to which neither the public trustee nor any of his officers has in any way contributed, and which neither he nor any of his officers could by the exercise of reasonable diligence have averted, and in that case the public trustee shall not, nor shall the Consolidated Fund, be subject to any liability.

(2) All sums payable in pursuance of this section out of the Consolidated Fund shall be charged on and issued out of that fund or the growing produce thereof.

Supplemental provisions as to public trustee

10.—(1) A person aggrieved by any act or omission or decision of the public trustee in relation to any trust may apply to the Court, and the Court may make such order in the matter as the Court thinks just.

(2) Subject to rules of Court, an application under this section to the High Court shall be made to a judge of the Chancery Division of the High Court in chambers.

11.—(1) The public trustee shall not, nor shall any of his officers act under this Act for reward, except as provided by this Act.

(2) The public trustee may, subject to the rules made under this Act, employ for the purposes of any trust such solicitors, bankers, accountants, and brokers, or other persons as he may consider necessary, and in determining the persons to be so employed in relation to any trust the public trustee shall have regard to the interests of the trust, but subject to this shall, whenever practicable, take into consideration the wishes of the creator of the trust and of the other trustees (if any), and of the beneficiaries either expressed or as implied by the practice of the creator of the trust, or in the previous management of the trust.

(3) On behalf of the public trustee such person as may be prescribed may take any oath, make any declaration, verify any account, give personal attendance at any Court or place, and do any act or thing whatsoever which the public trustee is required or authorised to take, make, verify, give, or do: Provided that nothing in this Act or in any rule made under this Act shall confer upon any person not otherwise entitled thereto any right to appear, or act, or be heard in or before any Court or tribunal, on behalf or instead of the public trustee, or to do any act whatsoever on behalf or on the instructions of the public trustee, which could otherwise only be lawfully done by a barrister or a duly certified solicitor.

(4) Where any bond or security would be required from a private person upon the grant to him of administration, or upon his appointment to act in any capacity, the public trustee, if administration is granted to him or if he is appointed to act in such capacity as aforesaid, shall not be required to give such bond or security, but shall be subject to the same liabilities and duties as if he had given such bond or security.

(5) The entry of the public trustee by that name in the books of a company shall not constitute notice of a trust, and a company shall not be entitled to object to enter the name of the public trustee on its books by reason only that the public trustee is a corporation, and, in dealings with property, the fact that the person or one of the persons dealt with is the public trustee shall not of itself constitute notice of a trust.

12. The provisions of this Act with respect to the High Court shall, in their application to cases within the jurisdiction of a palatine Court, include that Court, and the public trustee shall provide an address within the county palatine where service upon him of any proceedings under this Act in such palatine Court may be effected; the rules of Court relating to the exercise of the jurisdiction of a palatine Court under this Act shall be made by the authority having power to make general rules and orders of that Court.

Investigation and audit of trust accounts

13.—(1) Subject to rules under this Act and unless the Court otherwise orders, the condition and accounts of any trust shall on an application being made and notice thereof given in the prescribed manner by any trustee or beneficiary, be investigated and audited by such solicitor or public accountant as may be agreed on by the applicant and the trustees or, in default of agreement, by the public trustee or some person appointed by him.

Provided that (except with the leave of the Court) such an investigation or audit shall not be required within twelve months after any such previous investigation or audit, and that a trustee or beneficiary shall not be appointed under this section to make an investigation or audit.

(2) The person making the investigation or audit (hereinafter called the auditor) shall have a right of access to the books, accounts, and vouchers of the trustees, and to any securities and documents of title held by them on account of the trust, and may require from them such information and explanation as may be necessary for the performance of his duties, and upon the completion of the investigation and audit shall forward to the applicant and to every trustee a copy of the accounts, together with a report thereon, and a certificate signed by him to the effect that the accounts exhibit a true view of the state of the affairs of the trust and that he has had the securities of the trust fund investments produced to and verified by him or (as the case may be) that such accounts are deficient in such respects as may be specified in such certificate.

(3) Every beneficiary under the trust shall, subject to rules under this Act, be entitled at all reasonable times to inspect and take copies of the accounts, report, and certificate, and, at his own expense, to be furnished with copies thereof or extracts therefrom.

(4) The auditor may be removed by order of the Court, and, if any auditor is removed, or resigns, or dies, or becomes bankrupt or incapable of acting before the investigation and audit is completed, a new auditor may be appointed in his place in like manner as the original auditor.

(5) The remuneration of the auditor and the other expenses of the investigation and audit shall be such as may be prescribed by rules under this Act, and shall, unless the public trustee otherwise directs, be borne by the estate; and, in the event of the public trustee so directing, he may order that such expenses be borne by the applicant or by the trustees personally or partly by them and partly by the applicant.

(6) If any person having the custody of any documents to which the auditor has a right of access under this section fails or refuses to allow him to have access thereto or in anywise obstructs the investigation or audit, the auditor may apply to the Court, and thereupon the Court shall make such order as it thinks just.

(7) Subject to rules of Court, applications under or for the purposes of this section to the High Court shall be made to a judge of the Chancery Division in chambers.

(8) If any person in any statement of accounts, report, or certificate required for the purposes of this section wilfully makes a statement false in any material particular, he shall be liable on conviction or indictment to imprisonment for a term not exceeding two years, and on summary conviction to imprisonment for a term not exceeding six months, with or without hard labour, and in either case to a fine in lieu of or in addition to such imprisonment.

THE TRUSTEE ACT, 1925

15 Geo. 5, Ch. 19

PART I

INVESTMENTS

Authorised investments

1.—(1) A trustee may invest any trust funds in his hands, whether at the time in a state of investment or not, in manner following, that is to say:

- (a) In any of the Parliamentary Stocks or public funds or Government securities of the United Kingdom;
- (b) On real or heritable securities in the United Kingdom, including the security of a charge on freehold land by way of legal mortgage and a charge under Section 33 of the Finance Act, 1896;
- (c) In the stock of the Bank of England or the Bank of Ireland;
- (d) In India seven, five and a half, four and a half, three and a half, three and two and a half per cent. stock, or in any other capital stock which may at any time be issued by the Secretary of State in Council of India under the authority of any Act of Parliament, and charged on the revenues of India, or any other securities the interest in sterling whereon is payable out of and charged on the revenues of India;
- (e) In any securities the interest of which is for the time being guaranteed by Parliament;
- (f) In consolidated stock created by the Metropolitan Board of Works, or by the London County Council, or in debenture stock created by the Receiver for the Metropolitan Police District, or in Metropolitan Water Stock;
- (g) In the debenture or rent-charge, or guaranteed or preference, stock of any railway company in the United Kingdom incorporated by special Act of Parliament, and having during each of the ten years last past before the date of investment paid a dividend at the rate of not less than three per centum on its ordinary stock;

- (h) In the stock of any railway or canal company in the United Kingdom whose undertaking is leased in perpetuity or for a term of not less than two hundred years at a fixed rental to any such railway company as is mentioned in paragraph (g) of this subsection, either alone, or jointly with any other railway company;
 - (i) In the debenture stock of any company owning or operating a railway in India the interest in sterling on which is paid or guaranteed by the Secretary of State in Council of India;
 - (j) In the 'B' annuities of the Eastern Bengal, the East Indian, the Scinde Punjab and Delhi, Great Indian Peninsula and Madras Railways, or in any securities substituted therefor, and any like annuities which may at any time after the commencement of this Act be created on the purchase of any other railway by the Secretary of State in Council of India and charged on the revenues of India, and which may be authorised by Act of Parliament to be accepted by trustees in lieu of any stock held by them in the purchased railway; also in deferred annuities comprised in the register of holders of annuity class D and annuities comprised in the register of annuitants class C of the East Indian Railway Company;
 - (k) In the stock of any company owning or operating a railway in India upon which a fixed or minimum dividend in sterling is paid or guaranteed by the Secretary of State in Council of India, or upon the capital of which the interest is so guaranteed;
 - (l) *In the debenture or guaranteed or preference stock of any company in the United Kingdom established for the supply of water for profit, and incorporated by special Act of Parliament or by Royal Charter, and having during each of the ten years last past before the date of investment paid a dividend of not less than five per centum on its ordinary stock;
 - (m) In nominal or inscribed stock issued, or to be issued, under the authority of any Act of Parliament or Provisional Order, by the corporation of any municipal borough in the United Kingdom having, according to the returns of the last census prior to the date of investment, a population exceeding fifty thousand, or by any County Council in the United Kingdom;
 - (n) In nominal or inscribed stock issued or to be issued by any Commissioners incorporated by Act of Parliament for the purpose of supplying water, and having a compulsory power of levying rates over an area having according to the returns of the last census prior to the date of investment a population exceeding fifty thousand, provided that during each of the ten years last past before the date of investment the rates levied by such Commissioners have not exceeded eighty per centum of the amount authorised by law to be levied;
 - (o) In any stocks, funds, or securities authorised under the Colonial Stock Act, 1900, or any Act extending the same, but subject to any restrictions thereby imposed;
 - (p) In any local bonds issued under the Housing (Additional Powers) Act, 1919, and mortgages of any fund or rate granted after the passing of that Act under the authority of any Act or Provisional Order by a local authority (including a county council) which is authorised to issue local bonds under that Act;
 - (q) In any stock or securities issued in respect of any loan raised by the Government of Northern Ireland;
 - (r) In any of the stocks, funds, or securities for the time being authorised for the investment of cash under the control or subject to the order of the Court;
- and may also from time to time vary any such investment.

(2) For the purposes of this section—

- (a) the London and North Eastern Railway Company, the Southern Railway Company, the London, Midland & Scottish Railway Company, and the Great Western Railway Company shall each be treated as if it were a railway company in Great Britain incorporated by a special Act of Parliament which had in each of the ten years immediately before the date of amalgamation paid a dividend at a rate of not less than three per centum

* See paragraph 26, Third Schedule, Water Act, 1945.

on its ordinary stock, and for the purposes of this provision the date of amalgamation means—

- (i) as respects the London and North Eastern Railway Company and the Southern Railway Company the first day of January, nineteen hundred and twenty-three; and
- (ii) as respects the London, Midland & Scottish Railway Company and the Great Western Railway Company the first day of July, nineteen hundred and twenty-three;
- (b) a railway or canal company in Northern Ireland whose system is situate partly in Northern Ireland and partly in the Irish Free State shall not be deemed to be a railway or canal company in Northern Ireland.

Purchase at a premium of redeemable stocks; change of character of investment

2.—(1) A trustee may under the powers of this Act invest in any of the securities mentioned or referred to in Section 1 of this Act, notwithstanding that the same may be redeemable, and that the price exceeds the redemption value.

Provided that, in the case of any stock mentioned or referred to in paragraphs (g), (i), (k), (l), (m), (o), (p) of subsection (1) of Section 1 of this Act, which is liable to be redeemed at par or at some other fixed rate, a trustee shall not be entitled to purchase the stock—

- (a) at a price exceeding fifteen per centum above par or such other fixed rate; nor
 - (b) if the stock is liable to be so redeemed as aforesaid within fifteen years of the date of purchase, at a price exceeding its redemption value.
- (2) A trustee may retain until redemption any redeemable stock, fund, or security which may have been purchased in accordance with the powers of this Act, or any statute replaced by this Act.

Discretion of trustees

3. Every power conferred by the preceding sections shall be exercised according to the discretion of the trustee, but subject to any consent or direction required by the instrument, if any, creating the trust or by statute with respect to the investment of the trust funds.

Power to retain investment which has ceased to be authorised

4. A trustee shall not be liable for breach of trust by reason only of his continuing to hold an investment which has ceased to be an investment authorised by the trust instrument or by the general law.

Enlargement of powers of investment

5.—(1) A trustee having power to invest in real securities may invest and shall be deemed always to have had power to invest—

- (a) on mortgage of property held for an unexpired term of not less than two hundred years, and not subject to a reservation of rent greater than a shilling a year, or to any right of redemption or to any condition for re-entry, except for non-payment of rent; and
- (b) on any charge, or upon mortgage of any charge, made under the Improvement of Land Act, 1864.

(2) A trustee having power to invest in real securities may accept the security in the form of a charge by way of legal mortgage, and may, in exercise of the statutory power, convert an existing mortgage into a charge by way of legal mortgage.

(3) A trustee having power to invest in the mortgages or bonds of any railway company or of any other description of company may invest in the debenture stock of a railway company or such other company as aforesaid.

(4) A trustee having power to invest money in the debentures or debenture stock of any railway or other company may invest in any nominal debentures or nominal debenture stock issued under the Local Loans Act, 1875.

(5) A trustee having power to invest money in securities in the Isle of Man or in securities of the government of a colony, may invest in any securities of the Government of the Isle of Man, under the Isle of Man Loans Act, 1880.

(6) A trustee having a general power to invest trust money in or upon the security of shares, stock, mortgages, bonds, or debentures of companies incorporated by or acting under the authority of an Act of Parliament, may invest in, or upon the security of, mortgage debentures duly issued under and in accordance with the provisions of the Mortgage Debenture Act, 1865.

Power to invest in land subject to drainage charges

6. A trustee having power to invest in the purchase of land or on mortgage of land may invest in the purchase or on mortgage of any land notwithstanding the same is charged with a rent under the powers of the Public Money Drainage Acts, 1846 to 1856, or the Landed Property Improvement (Ireland) Act, 1847, or by an absolute order made under the Improvement of Land Act, 1864, unless the terms of the trust expressly provide that the land to be purchased or taken in mortgage shall not be subject to any such prior charge.

Investment in bearer securities

7.—(1) A trustee may, unless expressly prohibited by the instrument creating the trust, retain or invest in securities payable to bearer which, if not so payable, would have been authorised investments;

Provided that securities to bearer retained or taken as an investment by a trustee (not being a trust corporation) shall, until sold, be deposited by him for safe custody and collection of income with a banker or banking company.

A direction that investments shall be retained or made in the name of a trustee shall not, for the purposes of this subsection, be deemed to be such an express prohibition as aforesaid.

(2) A trustee shall not be responsible for any loss incurred by reason of such deposit, and any sum payable in respect of such deposit and collection shall be paid out of the income of the trust property.

Loans and investments by trustees not chargeable as breaches of trust

8.—(1) A trustee lending money on the security of any property on which he can properly lend shall not be chargeable with breach of trust by reason only of the proportion borne by the amount of the loan to the value of the property at the time when the loan was made, if it appears to the Court—

(a) that in making the loan the trustee was acting upon a report as to the value of the property made by a person whom he reasonably believed to be an able practical surveyor or valuer instructed and employed independently of any owner of the property, whether such surveyor or valuer carried on business in the locality where the property is situate or elsewhere; and

(b) that the amount of the loan does not exceed two-third parts of the value of the property as stated in the report; and

(c) that the loan was made under the advice of the surveyor or valuer expressed in the report.

(2) A trustee lending money on the security of any leasehold property shall not be chargeable with breach of trust only upon the ground that in making such loan he dispensed either wholly or partly with the production or investigation of the lessor's title.

(3) A trustee shall not be chargeable with breach of trust only upon the ground that in effecting the purchase, or in lending money upon the security, of any property he has accepted any shorter title than the title which a purchaser is, in the absence of a special contract entitled to require, if in the opinion of the Court the title accepted be such as a person acting with prudence and caution would have accepted.

(4) This section applies to transfers of existing securities as well as to new securities and to investments made before as well as after the commencement of this Act.

Liability for loss by reason of improper investment

9.—(1) Where a trustee improperly advances trust money on a mortgage security which would at the time of the investment be a proper investment in all respects for a smaller sum than is actually advanced thereon, the security

shall be deemed an authorised investment for the smaller sum, and the trustee shall only be liable to make good the sum advanced in excess thereof with interest.

(2) This section applies to investments made before as well as after the commencement of this Act.

Powers supplementary to powers of investment

10.—(1) Trustees lending money on the security of any property on which they can lawfully lend may contract that such money shall not be called in during any period not exceeding seven years from the time when the loan was made, provided interest be paid within a specified time not exceeding thirty days after every half-yearly or other day on which it becomes due, and provided there be no breach of any covenant by the mortgagor contained in the instrument of mortgage or charge for the maintenance and protection of the property.

(2) On a sale of land for an estate in fee simple or for a term having at least five hundred years to run by trustees or by a tenant for life or statutory owner, the trustees, or the tenant for life or statutory owner on behalf of the trustees of the settlement, may, where the proceeds are liable to be invested, contract that the payment of any part, not exceeding two-thirds, of the purchase money shall be secured by a charge by way of legal mortgage or a mortgage by demise or sub-demise for a term of at least five hundred years (less a nominal reversion when by sub-demise), of the land sold, with or without the security of any other property, such charge or mortgage, if any buildings are comprised in the mortgage, to contain a covenant by the mortgagor to keep them insured against loss or damage by fire to the full value thereof.

The trustees shall not be bound to obtain any report as to the value of the land or other property to be comprised in such charge or mortgage, or any advice as to the making of the loan, and shall not be liable for any loss which may be incurred by reason only of the security being insufficient at the date of the charge or mortgage; and the trustees of the settlement shall be bound to give effect to such contract made by the tenant for life or statutory owner.

(3) Where any securities of a company are subject to a trust, the trustees may concur in any scheme or arrangement—

- (a) for the reconstruction of the company;
- (b) for the sale of all or any part of the property and undertaking of the company to another company;
- (c) for the amalgamation of the company with another company;
- (d) for the release, modification or variation of any rights, privileges or liabilities attached to the securities or any of them;

in like manner as if they were entitled to such securities beneficially with power to accept any securities of any denomination or description of the reconstructed or purchasing or new company in lieu or in exchange for all or any of the first-mentioned securities; and the trustees shall not be responsible for any loss occasioned by any act or thing so done in good faith, and may retain any securities so accepted as aforesaid for any period for which they could have properly retained the original securities.

(4) If any conditional or preferential right to subscribe for any securities in any company is offered to trustees in respect of any holding in such company, they may as to all or any of such securities, either exercise such right and apply capital money subject to the trust in payment of the consideration, or renounce such right, or assign for the best consideration that can be reasonably obtained the benefit of such right or the title thereto to any person, including any beneficiary under the trust, without being responsible for any loss occasioned by any act or thing so done by them in good faith:

Provided that the consideration for any such assignment shall be held as capital money of the trust.

(5) The powers conferred by this section shall be exercisable subject to the consent of any person whose consent to a change of investment is required by law or by the instrument, if any, creating the trust.

(6) Where the loan referred to in subsection (1), or the sale referred to in subsection (2), of this section is made under the order of the Court, the powers conferred by those subsections respectively shall apply only if and as far as the Court may by order direct.

Power to deposit money at bank and to pay calls

11.—(1) Trustees may, pending the negotiation and preparation of any mortgage or charge, or during any other time while an investment is being sought for, pay any trust money into a bank to a deposit or other account, and all interest, if any, payable in respect thereof shall be applied as income.

(2) Trustees may apply capital money subject to a trust in payment of the calls on any shares subject to the same trust.

Devolution of powers or trusts

18.—(1) Where a power or trust is given to or imposed on two or more trustees jointly, the same may be exercised or performed by the survivors or survivor of them for the time being.

(2) Until the appointment of new trustees, the personal representatives or representative for the time being of a sole trustee, or, where there were two or more trustees of the last surviving or continuing trustee, shall be capable of exercising or performing any power or trust which was given to, or capable of being exercised by, the sole or last surviving or continuing trustee, or other the trustees or trustee for the time being of the trust.

(3) This section takes effect subject to the restrictions imposed in regard to receipts by a sole trustee, not being a trust corporation.

(4) In this section 'personal representative' does not include an executor who has renounced or has not proved.

Power to insure

19.—(1) A trustee may insure against loss or damage by fire any building or other insurable property to any amount, including the amount of any insurance already on foot, not exceeding three-fourths parts of the full value of the building or property, and pay the premiums for such insurance out of the income thereof or out of the income of any other property subject to the same trusts without obtaining the consent of any person who may be entitled wholly or partly to such income.

(2) This section does not apply to any building or property which a trustee is bound forthwith to convey absolutely to any beneficiary upon being requested to do so.

Application of insurance money where policy kept up under any trust, power or obligation

20.—(1) Money receivable by trustees or any beneficiary under a policy of insurance against the loss or damage of any property subject to a trust or to a settlement within the meaning of the Settled Land Act, 1925, whether by fire or otherwise, shall, where the policy has been kept up under any trust in that behalf or under any power statutory or otherwise, or in performance of any covenant or of any obligation statutory or otherwise, or by a tenant for life impeachable for waste, be capital money for the purposes of the trust or settlement, as the case may be.

(2) If any such money is receivable by any person, other than the trustees of the trust or settlement, that person shall use his best endeavours to recover and receive the money, and shall pay the net residue thereof, after discharging any costs, of recovering and receiving it, to the trustees of the trust or settlement, or, if there are no trustees capable of giving a discharge therefor, into Court.

(3) Any such money—

(a) if it was receivable in respect of settled land within the meaning of the Settled Land Act, 1925, or any building or works thereon, shall be deemed to be capital money arising under that Act from the settled land, and shall be invested or applied by the trustees, or, if in Court, under the direction of the Court, accordingly;

(b) if it was receivable in respect of personal chattels settled as heirlooms within the meaning of the Settled Land Act, 1925, shall be deemed to be capital money arising under that Act, and shall be applicable by the trustees, or, if in Court, under the direction of the Court, in like manner as provided by that Act with respect to money arising by a sale of chattels settled as heirlooms as aforesaid;

- (c) if it was receivable in respect of property held upon trust for sale, shall be held upon the trusts and subject to the power and provisions applicable to money arising by a sale under such trust;
- (d) in any other case, shall be held upon trusts corresponding as nearly as may be with the trusts affecting the property in respect of which it was payable.

(4) Such money, or any part thereof, may also be applied by the trustees, or, if in Court, under the direction of the Court, in rebuilding, reinstating, replacing, or repairing the property lost or damaged, but any such application by the trustees shall be subject to the consent of any person whose consent is required by the instrument, if any, creating the trust to the investment of money subject to the trust, and, in the case of money which is deemed to be capital money arising under the Settled Land Act, 1925, be subject to the provisions of that Act with respect to the application of capital money by the trustees of the settlement.

(5) Nothing contained in this section prejudices or affects the right of any person to require any such money or any part thereof to be applied in rebuilding, reinstating, or repairing the property lost or damaged, or the rights of any mortgagee, lessor, or lessee, whether under any statute or otherwise.

(6) This section applies to policies effected either before or after the commencement of this Act, but only to money received after such commencement.

Deposit of documents for safe custody

21. Trustees may deposit any documents held by them relating to the trust, or to the trust property, with any banker or banking company or any other company whose business includes the undertaking of the safe custody of documents, and any sum payable in respect of such deposit shall be paid out of the income of the trust property.

Reversionary interests, valuations and audit

22.—(1) Where trust property includes any share or interest in property not vested in the trustees, or the proceeds of the sale of any such property, or any other thing in action, the trustees on the same falling into possession, or becoming payable or transferable may—

- (a) agree or ascertain the amount or value thereof or any part thereof in such manner as they may think fit;
- (b) accept in or towards satisfaction thereof, at the market or current value, or upon any valuation or estimate of value which they may think fit, any authorised investments;
- (c) allow any deductions for duties, costs, charges and expenses which they may think proper or reasonable;
- (d) execute any release in respect of the premises so as effectually to discharge all accountable parties from all liability in respect of any matters coming within the scope of such release;

without being responsible in any such case for any loss occasioned by any act or thing so done by them in good faith.

(2) The trustees shall not be under any obligation and shall not be chargeable with any breach of trust by reason of any omission—

- (a) to place any distringas notice or apply for any stop or other like order upon any securities or other property out of or on which such share or interest or other thing in action as aforesaid is derived, payable or charged; or
- (b) to take any proceedings on account of any act, default, or neglect on the part of the persons in whom such securities or other property or any of them or any part thereof are for the time being, or had at any time been, vested;

unless and until required in writing so to do by some person, or the guardian of some person, beneficially interested under the trust, and unless also due provision is made to their satisfaction for payment of the costs of any proceedings required to be taken:

Provided that nothing in this subsection shall relieve the trustees of the obligation to get in and obtain payment or transfer of such share or interest or other thing in action on the same falling into possession.

(3) Trustees may, for the purpose of giving effect to the trust, or any of the provisions of the instrument, if any, creating the trust or of any statute, from time to time (by duly qualified agents) ascertain and fix the value of any trust property in such manner as they think proper, and any valuation so made in good faith shall be binding upon all persons interested under the trust.

(4) Trustees may, in their absolute discretion, from time to time, but not more than once in every three years unless the nature of the trust or any special dealings with the trust property make a more frequent exercise of the right reasonable, cause the accounts of the trust property to be examined or audited by an independent accountant, and shall, for that purpose, produce such vouchers and give such information to him as he may require; and the costs of such examination or audit, including the fee of the auditor, shall be paid out of the capital or income of the trust property, or partly in one way and partly in the other, as the trustees, in their absolute discretion, think fit, but, in default of any direction by the trustees to the contrary in any special case, costs attributable to capital shall be borne by capital and those attributable to income by income.

Power to employ agents

23.—(1) Trustees or personal representatives may, instead of acting personally, employ and pay an agent, whether a solicitor, banker, stockbroker, or other person, to transact any business or do any act required to be transacted or done in the execution of the trust, or the administration of the testator's or intestate's estate, including the receipt and payment of money, and shall be entitled to be allowed and paid all charges and expenses so incurred and shall not be responsible for the default of any such agent if employed in good faith.

(2) Trustees or personal representatives may appoint any person to act as their agent or attorney for the purpose of selling, converting, collecting, getting in, and executing and perfecting insurances of, or managing or cultivating, or otherwise administering any property, real or personal, movable or immovable, subject to the trust or forming part of the testator's or intestate's estate, in any place outside the United Kingdom or executing or exercising any discretion or trust or power vested in them in relation to any such property, with such ancillary powers, and with and subject to such provisions and restrictions as they may think fit, including a power to appoint substitutes, and shall not, by reason only of their having made such appointment, be responsible for any loss arising thereby.

(3) Without prejudice to such general power of appointing agents as aforesaid—

- (a) A trustee may appoint a solicitor to be his agent to receive and give a discharge for any money or valuable consideration or property receivable by the trustee under the trust, by permitting the solicitor to have the custody of, and to produce, a deed having in the body thereof or endorsed thereon a receipt for such money or valuable consideration or property, the deed being executed, or the endorsed receipt being signed, by the person entitled to give a receipt for that consideration;
- (b) A trustee shall not be chargeable with breach of trust by reason only of his having made or concurred in making any such appointment; and the production of any such deed by the solicitor shall have the same statutory validity and effect as if the person appointing the solicitor had not been a trustee.
- (c) A trustee may appoint a banker or solicitor to be his agent to receive and give a discharge for any money payable to the trustee under or by virtue of a policy of insurance, by permitting the banker or solicitor to have the custody of and to produce the policy of insurance with a receipt signed by the trustee, and a trustee shall not be chargeable with a breach of trust by reason only of his having made or concurred in making any such appointment:

Provided that nothing in this subsection shall exempt a trustee from any liability which he would have incurred if this Act and any enactment replaced by this Act had not been passed, in case he permits any such money, valuable consideration, or property to remain in the hands or under the control of the banker or solicitor for a period longer than is reasonably necessary to enable the banker or solicitor, as the case may be, to pay or transfer the same to the trustee.

This subsection applies whether the money or valuable consideration or property was or is received before or after the commencement of this Act.

Protection by means of advertisement

27.—(1) With a view to the conveyance to or distribution among the persons entitled to any real or personal property, the trustees of a settlement or of a disposition on trust for sale or personal representatives, may give notice by advertisement in the *Gazette*, and in a daily London newspaper, and also if the property includes land not situated in London in a daily or weekly newspaper circulating in the district in which the land is situated, and such other like notices, including notices elsewhere than in England and Wales, as would, in any special case, have been directed by a court of competent jurisdiction in an action for administration, of their intention to make such conveyance or distribution as aforesaid, and requiring any person interested to send to the trustees or personal representatives within the time, not being less than two months, fixed in the notice or, where more than one notice is given, in the last of the notices, particulars of his claim in respect of the property or any part thereof to which the notice relates.

(2) At the expiration of the time fixed by the notice the trustees or personal representatives may convey or distribute the property or any part thereof to which the notice relates, to or among the persons entitled thereto, having regard only to the claims, whether formal or not, of which the trustees or personal representatives then had notice and shall not, as respects the property so conveyed or distributed, be liable to any person of whose claim the trustees or personal representatives have not had notice at the time of conveyance or distribution; but nothing in this section—

- (a) prejudices the right of any person to follow the property or any property representing the same, into the hands of any person, other than a purchaser, who may have received it; or
 - (b) frees the trustees or personal representatives from any obligation to make searches or obtain official certificates of search similar to those which an intending purchaser would be advised to make or obtain.
- (3) This section applies notwithstanding anything to the contrary in the will or other instrument, if any, creating the trust.

Protection in regard to notice

28. A trustee or personal representative acting for the purposes of more than one trust or estate shall not, in the absence of fraud, be affected by notice of any instrument, matter, fact, or thing in relation to any particular trust or estate if he has obtained notice thereof merely by reason of his acting or having acted for the purposes of another trust or estate.

MAINTENANCE, ADVANCEMENT AND PROTECTIVE TRUSTS

Power to apply income for maintenance and to accumulate surplus income during a minority

31.—(1) Where any property is held by trustees in trust for any person for any interest whatsoever, whether vested or contingent, then, subject to any prior interests or charges affecting that property—

- (i) during the infancy of any such person, if his interest so long continues, the trustees may, at their sole discretion, pay to his parent or guardian, if any, or otherwise apply for or towards his maintenance, education, or benefit, the whole or such part, if any, of the income of that property as may, in all the circumstances, be reasonable, whether or not there is—

- (a) any other fund applicable to the same purpose; or
 - (b) any person bound by law to provide for his maintenance or education;
- and

- (ii) if such person on attaining the age of twenty-one years has not a vested interest in such income, the trustees shall thenceforth pay the income of that property and of any accretion thereto under subsection (2) of this section to him, until he either attains a vested interest therein or dies, or until failure of his interest;

Provided that, in deciding whether the whole or any part of the income of the

property is during a minority to be paid or applied for the purposes aforesaid, the trustees shall have regard to the age of the infant and his requirements and generally to the circumstances of the case, and in particular to what other income, if any, is applicable for the same purposes; and where trustees have notice that the income of more than one fund is applicable for those purposes, then, so far as practicable, unless the entire income of the funds is paid or applied as aforesaid or the Court otherwise directs, a proportionate part only of the income of each fund shall be so paid or applied.

(2) During the infancy of any such person, if his interest so long continues, the trustees shall accumulate all the residue of that income in the way of compound interest by investing the same and the resulting income thereof from time to time in authorised investments, and shall hold those accumulations as follows:

(i) If any such person—

- (a) attains the age of twenty-one years, or marries under that age, and his interest in such income during his infancy or until his marriage is a vested interest; or
- (b) on attaining the age of twenty-one years or on marriage under that age becomes entitled to the property from which such income arose in fee simple, absolute, or determinable, or absolutely, or for an entailed interest;

the trustees shall hold the accumulations in trust for such person absolutely, but without prejudice to any provision with respect thereto contained in any settlement by him made under any statutory powers during his infancy, and so that the receipt of such person after marriage, and though still an infant, shall be a good discharge; and

- (ii) In any other case the trustees shall, notwithstanding that such person had vested interest in such income, hold the accumulations as an accretion to the capital of the property from which such accumulations arose, and as one fund with such capital for all purposes, and so that, if such property is settled land, such accumulations shall be held upon the same trusts as if the same were capital money arising therefrom;

but the trustees may, at any time during the infancy of such person if his interest so long continues, apply those accumulations, or any part thereof, as if they were income arising in the then current year.

(3) This section applies in the case of a contingent interest only if the limitation or trust carries the intermediate income of the property, but it applies to a future or contingent legacy by the parent of, or a person standing *in loco parentis* to, the legatee, if and for such period as, under the general law, the legacy carries interest for the maintenance of the legatee, and in any such case as last aforesaid the rate of interest shall (if the income available is sufficient, and subject to any rules of Court to the contrary) be five pounds per centum per annum.

(4) This section applies to a vested annuity in like manner as if the annuity were the income of property held by trustees in trust to pay the income thereof to the annuitant for the same period for which the annuity is payable, save that in any case accumulations made during the infancy of the annuitant shall be held in trust for the annuitant or his personal representatives absolutely.

(5) This section does not apply where the instrument, if any, under which the interest arises came into operation before the commencement of this Act.

Power of advancement

32.—(1) Trustees may at any time or times pay or apply any capital money subject to a trust, for the advancement or benefit, in such manner as they may, in their absolute discretion, think fit, of any person entitled to the capital of the trust property or of any share thereof, whether absolutely or contingently on his attaining any specified age or on the occurrence of any other event, or subject to a gift over on his death under any specified age or on the occurrence of any other event, and whether in possession or in remainder or reversion, and such payment or application may be made notwithstanding that the interest of such person is liable to be defeated by the exercise of a power of appointment or revocation, or to be diminished by the increase of the class to which he belongs:

Provided that—

- (a) the money so paid or applied for the advancement or benefit of any person

shall not exceed altogether in amount one-half of the presumptive or vested share or interest of that person in the trust property; and

- (b) if that person is or becomes absolutely and indefeasibly entitled to a share in trust property the money so paid or applied shall be brought into account as part of such share; and
- (c) no such payment or application shall be made so as to prejudice any person entitled to any prior life or other interest, whether vested or contingent, in the money paid or applied unless such person is in existence and of full age and consents in writing to such payment or application.

(2) This section applies only where the trust property consists of money or securities or of property held upon trust for sale calling in and conversion, and such money or securities, or the proceeds of such sale calling in and conversion are not by statute or in equity considered as land, or applicable as capital money for the purposes of the Settled Land Act, 1925.

(3) This section does not apply to trusts constituted or created before the commencement of this Act.

Protective trusts

33.—(1) Where any income, including an annuity or other periodical income payment, is directed to be held on protective trusts for the benefit of any person (in this section called 'the principal beneficiary') for the period of his life or for any less period, then, during that period (in this section called the 'trust period') the said income shall, without prejudice to any prior interest, be held on the following trusts, namely:

- (i) Upon trust for the principal beneficiary during the trust period or until he, whether before or after the termination of any prior interest, does or attempts to do or suffers any act, or thing, or until any event happens, other than an advance under any statutory or express power, whereby, if the said income were payable during the trust period to the principal beneficiary absolutely during that period, he would be deprived of the right to receive the same or any part thereof, in any of which cases, as well as on the termination of the trust period, whichever first happens, this trust of the said income shall fail or determine,

- (ii) If the trust aforesaid fails or determines during the subsistence of the trust period, then, during the residue of that period, the said income shall be held upon trust for the application thereof for the maintenance or support, or otherwise for the benefit, of all or any one or more exclusively of the other or others of the following persons (that is to say)—

(a) the principal beneficiary and his or her wife or husband, if any, and his or her children or more remote issue, if any; or

(b) if there is no wife or husband or issue of the principal beneficiary in existence, the principal beneficiary and the persons who would, if he were actually dead, be entitled to the trust property or the income thereof or to the annuity fund, if any, or arrears of the annuity, as the case may be;

as the trustees in their absolute discretion, without being liable to account for the exercise of such discretion, think fit.

(2) This section does not apply to trusts coming into operation before the commencement of this Act, and has effect subject to any variation of the implied trusts aforesaid contained in the instrument creating the trust.

(3) Nothing in this section operates to validate any trust which would, if contained in the instrument creating the trust, be liable to be set aside.

Power to authorise remuneration

42. Where the Court appoints a corporation, other than the public trustee, to be a trustee either solely or jointly with another person, the Court may authorise the corporation to charge such remuneration for his services as trustee as the Court may think fit.

Power to relieve trustee from personal liability

61. If it appears to the Court that a trustee, whether appointed by the Court or otherwise, is or may be personally liable for any breach of trust, whether the transaction alleged to be a breach of trust occurred before or after the commence-

ment of this Act, but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the Court in the matter in which he committed such breach, then the Court may relieve him either wholly or partly from personal liability for the same.

Power to make beneficiary indemnify for breach of trust

62.—(1) Where a trustee commits a breach of trust at the instigation or request or with the consent in writing of a beneficiary, the Court may, if it thinks fit, and notwithstanding that the beneficiary may be a married woman restrained from anticipation make such order as to the Court seems just, for impounding all or any part of the interest of the beneficiary in the trust estate by way of indemnity to the trustee or persons claiming through him.

(2) This section applies to breaches of trust committed as well before as after the commencement of this Act.

Short title, commencement, extent

71.—(1) This Act may be cited as the Trustee Act, 1925.

(2) This Act shall come into operation on the first day of January, nineteen hundred and twenty-six.

(3) This Act, except where otherwise expressly provided, extends to England and Wales only.

(4) The provisions of this Act bind the Crown.

FIRST SCHEDULE

RETROSPECTIVE AMENDMENTS

(1) The investments mentioned in paragraphs (d), (i) and (k) of Section 1 of the Trustee Act, 1893, and in the corresponding provisions of any enactment replaced by that Act, shall be deemed always to have included investments mentioned in paragraphs (d), (i) and (k) of subsection (1) of Section 1 of this Act.

(2) In subsection (3) of Section 12 of the Trustee Act, 1893, and in the enactment which it replaced, the expression 'customary land' shall be deemed never to have included land in regard to which a tenant had power to dispose of the legal estate by deed, and the expression 'land conveyed by way of mortgage' shall be deemed never to have included land conveyed in trust for securing debentures or debenture stock.

(3) Section 47 of the Trustee Act, 1893, shall be deemed, always to have had effect as if after the words 'Settled Land Acts, 1882 to 1890', there had been inserted the words 'and trustees for the purposes of Section 42 of the Conveyancing Act, 1881'.

(4) Subsection (1) of Section 8 of the Conveyancing Act, 1911, shall be deemed always to have had effect as if at the end thereof there had been inserted the words 'or other the trustees or trustee for the time being of the trust'.

THE LAW OF PROPERTY ACT, 1925

15 Geo. 5, Ch. 20

Powers of management, &c., conferred on trustees for sale

28.—(1) Trustees for sale shall, in relation to land or to manorial incidents and to the proceeds of sale, have all the powers of a tenant-for-life and the trustees of a settlement under the Settled Land Act, 1925, including in relation to the land the powers of management conferred by that Act during a minority: and (subject to any express trust to the contrary) all capital money arising under the said powers shall, unless paid or applied for any purpose authorised by the Settled Land Act, 1925, be applicable in the same manner as if the money represented proceeds of sale arising under the trust for sale.

All land acquired under this subsection shall be conveyed to the trustees on trust for sale.

The powers conferred by this subsection shall be exercised with such consents (if any) as would have been required on a sale under the trust for sale, and when exercised shall operate to overreach any equitable interests or powers which are by virtue of this Act or otherwise made to attach to the net proceeds of sale as if created by a trust affecting those proceeds.

(2) Subject to any direction to the contrary in the disposition on trust for sale or in the settlement of the proceeds of sale, the net rents and profits of the land, until sale, after keeping down costs of repairs and insurance and other outgoings shall be paid or applied, except so far as any part thereof may be liable to be set aside as capital money under the Settled Land Act, 1925, in like manner as the income of investments representing the purchase money would be payable or applicable if a sale had been made and the proceeds had been duly invested.

(3) Where the net proceeds of sale have under the trusts affecting the same become absolutely vested in persons of full age in undivided shares (whether or not such shares may be subject to derivative trust) the trustees for sale may, with the consent of the persons, if any, of full age, not being annuitants, interested in possession in the net rents and profits of the land until sale:

(a) partition the land remaining unsold or any part thereof; and

(b) provide (by way of mortgage or otherwise) for the payment of any equality money;

and, upon such partition being arranged, the trustees for sale shall give effect thereto by conveying the land so partitioned in severalty (subject or not to any legal mortgage created for raising equality money) to persons of full age and either absolutely or on trust for sale or, where any part of the land becomes settled land by a vesting deed, or partly in one way and partly in another in accordance with the rights of the person interested under the partition, but a purchaser shall not be concerned to see or inquire whether any such consent as aforesaid has been given:

Provided that—

(i) If a share in the net proceeds belongs to a lunatic or defective, the consent of his committee or receiver shall be sufficient to protect the trustees for sale;

(ii) If a share in the net proceeds is affected by an incumbrance the trustees for sale may either give effect thereto or provide for the discharge thereof by means of the property allotted in respect of such share, as they may consider expedient.

(4) If a share in the net proceeds is absolutely vested in an infant, the trustees for sale may act on his behalf and retain land (to be held on trust for sale) or other property to represent his share, but in other respects the foregoing power shall apply as if the infant had been of full age.

(5) This section applies to dispositions on trust for sale coming into operation either before or after the commencement or by virtue of this Act.

THE ADMINISTRATION OF ESTATES ACT, 1925

15 Geo. 5, Ch. 23

Duties, rights and obligations

Duty of personal representative as to inventory

25. The personal representative of a deceased person shall, when lawfully required so to do, exhibit on oath in the Court a true and perfect inventory and account of the real and personal estate of the deceased, and the Court shall have power as heretofore to require personal representatives to bring in inventories.

PART III

ADMINISTRATION OF ASSETS

Real and personal estate of deceased are assets for payment of debts

32.—(1) The real and personal estate, whether legal or equitable of a deceased person, to the extent of his beneficial interest therein, and the real and personal estate of which a deceased person in pursuance of any general power (including the statutory power to dispose of entailed interests) disposes by his will, are assets

for payment of his debts (whether by specialty or simple contract) and liabilities, and any disposition by will inconsistent with this enactment is void as against the creditors, and the Court shall, if necessary, administer the property for the purpose of the payment of the debts and liabilities.

This subsection takes effect without prejudice to the rights of incumbrances.

(2) If any person to whom any such beneficial interest devolves or is given, or in whom any such interest vests, disposes thereof in good faith before an action is brought or process issued out against him, he shall be personally liable for the value of the interests so disposed of by him, but that interest shall not be liable to be taken in execution in the action or under the process.

Trust for sale

33.—(1) On the death of a person intestate as to any real or personal estate, such estate shall be held by his personal representatives—

(a) as to the real estate upon trust to sell the same; and

(b) as to the personal estate upon trust to call in sell and convert into money such part thereof as may not consist of money.

with power to postpone such sale and conversion for such a period as the personal representatives, without being liable to account, may think proper, and so that any reversionary interest be not sold until it falls into possession, unless the personal representatives see special reason for sale, and so also that, unless required for purposes of administration owing to want of other assets, personal chattels be not sold except for special reason.

(2) Out of the net money to arise from the sale and conversion of such real and personal estate (after payment of costs), and out of the ready money of the deceased (so far as not disposed of by his will, if any), the personal representatives shall pay all such funeral, testamentary and administration expenses, debts and other liabilities as are properly payable thereout having regard to the rules of administration contained in this Part of this Act, and out of the residue of the said money the personal representative shall set aside a fund sufficient to provide for any pecuniary legacies, bequeathed by the will (if any) of the deceased.

(3) During the minority of any beneficiary of the subsistence of any life interest and pending the distribution of the whole or any part of the estate of the deceased, the personal representatives may invest the residue of the said money, or so much thereof as may not have been distributed, in any investments for the time being authorised by statute for the investment of trust money, with power, at the discretion of the personal representatives, to change such investments for others of a like nature.

(4) The residue of the said money and any investments for the time being representing the same, including (but without prejudice to the trust for sale) any part of the estate of the deceased which may be retained unsold and is not required for the administration purposes aforesaid, is in this Act referred to as 'the residuary estate of the intestate'.

(5) The income (including net rents and profits of real estate and chattels real after payment of rates, taxes, rent, costs of insurance, repairs and other outgoings properly attributable to income) of so much of the real and personal estate of the deceased as may not be disposed of by his will, if any, or may not be required for the administration purposes aforesaid, may, however such estate is invested, as from the death of the deceased be treated and applied as income, and for that purpose any necessary apportionment may be made between tenant-for-life and remainderman.

(6) Nothing in this section affects the rights of any creditor of the deceased or the rights of the Crown in respect of death duties.

(7) Where the deceased leaves a will, this section has effect subject to the provisions contained in the will.

Administration of assets

34.—(1) Where the estate of a deceased person is insolvent, his real and personal estate shall be administered in accordance with the rules set out in Part I of the First Schedule to this Act.

(2) The right of retainer of a personal representative and his right to prefer creditors may be exercised in respect of all assets of the deceased, but the right of

retainer shall only apply to debts owing to the personal representative in his own right whether solely or jointly with another person.

Subject as aforesaid, nothing in this Act affects the right of retainer of a personal representative, or his right to prefer creditors.

(3) Where the estate of a deceased person is solvent his real and personal estate shall, subject to rules of Court and the provisions hereinafter contained as to charges on property of the deceased, and to the provisions, if any, contained in his will, be applicable towards the discharge of the funeral, testamentary and administration expenses, debts and liabilities payable thereout in the order mentioned in Part II of the First Schedule to this Act.

Charges on property of deceased to be paid primarily out of the property charged

35.—(1) Where a person dies possessed of, or entitled to, or under a general power of appointment (including the statutory power to dispose of entailed interests) by his will disposes of an interest in property, which at the time of his death is charged with the payment of money, whether by way of legal mortgage, equitable charge or otherwise (including a lien for unpaid purchase money), and the deceased has not by will deed or other document signified a contrary or other intention, the interest so charged shall, as between the different persons claiming through the deceased, be primarily liable for the payment of the charge and every part of the said interest, according to its value, shall bear a proportionate part of the charge on the whole thereof.

(2) Such contrary or other intention shall not be deemed to be signified—

(a) by a general direction for the payment of debts or of all the debts of the testator out of his personal estate, or his residuary real and personal estate, or his residuary real estate; or

(b) by a charge of debts upon any such estate; unless such intention is further signified by words expressly or by necessary implication referring to all or some part of the charge.

(3) Nothing in this section affects the right of a person entitled to the charge to obtain payment or satisfaction thereof either out of the other assets of the deceased or otherwise.

Powers of management

39.—(1) In dealing with the real and personal estate of the deceased his personal representatives shall, for purposes of administration, or during a minority of any beneficiary or the subsistence of any life interest, or until the period of distribution arrives have—

(i) the same powers and discretions, including power to raise money by mortgage or charge (whether or not by deposit of documents), as a personal representative had before the commencement of this Act, with respect to personal estate vested in him, and such power of raising money by mortgage may in the case of land be exercised by way of legal mortgage; and

(ii) all the powers, discretions and duties conferred or imposed by law on trustees holding land upon an effectual trust for sale (including power to overreach equitable interests and powers as if the same affected the proceeds of sale); and

(iii) all the powers conferred by statute on trustees for sale, and so that every contract entered into by a personal representative shall be binding on and be enforceable against and by the personal representative for the time being of the deceased, and may be carried into effect, or be varied or rescinded by him, and in the case of a contract entered into by a predecessor, as if it had been entered into by himself.

(2) Nothing in this section shall affect the right of any person to require an assent or conveyance to be made.

(3) This section applies whether the testator or intestate died before or after the commencement of this Act.

Powers of personal representative for raising money, &c.

40.—(1) For giving effect to beneficial interests the personal representative may limit or demise land for a term of years absolute, with or without impeachment

for waste, to trustees on usual trusts for raising or securing any principal sum and the interest thereon for which the land, or any part thereof, is liable, and may limit or grant a rent charge for giving effect to any annual or periodical sum for which the land or the income thereof or any part thereof is liable.

(2) This section applies whether the testator or intestate died before or after the commencement of this Act.

Powers of personal representative as to appropriation

41.—(1) The personal representative may appropriate any part of the real or personal estate, including things in action, of the deceased in the actual condition or state of investment thereof at the time of appropriation in or towards satisfaction of any legacy bequeathed by the deceased, or of any other interest or share in his property, whether settled or not, as to the personal representative may seem just and reasonable, according to the respective rights of the persons interested in the property of the deceased:

Provided that—

- (i) an appropriation shall not be made under this section so as to affect prejudicially any specific devise or bequest;
- (ii) an appropriation of property, whether or not being an investment authorised by law or by the will, if any, of the deceased for the investment of money subject to the trust shall not (save as hereinafter mentioned) be made under this section except with the following consents:
 - (a) when made for the benefit of a person absolutely and beneficially entitled in possession, the consent of that person;
 - (b) when made in respect of any settled legacy share or interest, the consent of either the trustee thereof, if any (not being also the personal representative), or the person who may for the time being be entitled to the income:

If the person whose consent is so required as aforesaid is an infant or a lunatic or defective, the consent shall be given on his behalf by his parents or parent, testamentary or other guardian, committee or receiver, or if, in the case of an infant, there is no such parent or guardian, by the Court on the application of his next friend;

- (iii) no consent (save of such trustee as aforesaid) shall be required on behalf of a person who may come into existence after the time of appropriation, or who cannot be found or ascertained at that time;
 - (iv) if no committee or receiver of a lunatic or defective has been appointed, then, if the appropriation is of an investment authorised by law or by the will, if any, of the deceased for the investment of money subject to the trust, no consent shall be required on behalf of the lunatic or defective;
 - (v) if, independently of the personal representative, there is no trustee of a settled legacy share or interest, and no person of full age and capacity entitled to the income thereof, no consent shall be required to an appropriation in respect of such legacy share or interest, provided that the appropriation is of an investment authorised as aforesaid.
- (2) Any property duly appropriated under the powers conferred by this section shall thereafter be treated as an authorised investment, and may be retained or dealt with accordingly.
- (3) For the purposes of such appropriation, the personal representative may ascertain and fix the value of the respective parts of the real and personal estate and the liabilities of the deceased as he may think fit, and shall for that purpose employ a duly qualified valuer in any case where such employment may be necessary; and may make any conveyance (including an assent) which may be requisite for giving effect to the appropriation.
- (4) An appropriation made pursuant to this section shall bind all persons interested in the property of the deceased whose consent is not hereby made requisite.
- (5) The personal representative shall, in making the appropriation, have regard to the rights of any person who may thereafter come into existence, or who cannot be found or ascertained at the time of appropriation and of any other person whose consent is not required by this section.
- (6) This section does not prejudice any other power of appropriation conferred

by law or by the will (if any) of the deceased, and takes effect with any extended powers conferred by the will (if any) of the deceased, and where an appropriation is made under this section, in respect of a settled legacy, share or interest, the property appropriated shall remain subject to all trusts for sale and powers of leasing, disposition, and management or varying investments which would have been applicable thereto or to the legacy, share or interest in respect of which the appropriation is made, if no such appropriation had been made.

(7) If after any real estate has been appropriated in purported exercise of the powers conferred by this section, the person to whom it was conveyed disposes of it or any interest therein, then in favour of a purchaser, the appropriation shall be deemed to have been made in accordance with the requirements of this section and after all requisite consents, if any, had been given.

(8) In this section, a settled legacy, share or interest includes any legacy, share or interest to which a person is not absolutely entitled in possession at the date of the appropriation, also an annuity, and 'purchaser' means a purchaser for money or money's worth.

(9) This section applies whether the deceased died intestate or not and whether before or after the commencement of this Act and extends to property over which the testator exercises a general power of appointment, including the statutory power to dispose of entailed interests, and authorises the setting apart of a fund to answer an annuity by means of the income of that fund or otherwise.

Power to appoint trustees of infants' property

42.—(1) Where an infant is absolutely entitled under the will or on the intestacy of a person dying before or after the commencement of this Act (in this subsection called 'the deceased') to a devise or legacy, or to the residue of the estate of the deceased, any share therein, and such devise, legacy, residue or share is not under the will, if any, of the deceased, devised or bequeathed to trustees for the infant, the personal representatives of the deceased may appoint a trust corporation or two or more individuals not exceeding four (whether or not including the personal representatives or one or more of the personal representatives), to be the trustee or trustees of such devise, legacy, residue or share for the infant, and to be trustees of any land devised or any land being or forming part of such residue or share for the purposes of the Settled Land Act, 1925, and of the statutory provisions relating to the management of land during a minority, and may execute or do any assurance or thing requisite for vesting such devise, legacy, residue or share in the trustee or trustees so appointed.

On such appointment the personal representatives, as such, shall be discharged from all further liability in respect of such devise, legacy, residue, or share, and the same may be retained in its existing condition or state of investment or may be converted into money, and such money may be invested in any authorised investment.

(2) Where a personal representative has, before the commencement of this Act, retained or sold any such devise, legacy, residue or share, and invested the same or the proceeds thereof in any investments in which he was authorised to invest money subject to the trust, then, subject to any order of the Court made before such commencement, he shall not be deemed to have incurred any liability on that account, or by reason of not having paid or transferred the money or property into Court.

Obligations of personal representatives as to giving possession of land and powers of the Court

43.—(1) A personal representative, before giving an assent or making a conveyance in favour of any person entitled, may permit that person to take possession of the land, and such possession shall not prejudicially affect the right of the personal representative to take or resume possession nor his power to convey the land as if he were in possession thereof, but subject to the interest of any lessee, tenant or occupier in possession or in actual occupation of the land.

(2) Any person who as against the personal representative claims possession of real estate, or the appointment of a receiver thereof, or a conveyance thereof, or an assent to the vesting thereof, or to be registered as proprietor thereof under the Land Registration Act, 1925, may apply to the Court for directions with

reference thereto, and the Court may make such vesting or other order as may be deemed proper, and the provisions of the Trustee Act, 1925, relating to vesting orders and to the appointment of a person to convey, shall apply.

(3) This section applies whether the testator or intestate died before or after the commencement of this Act.

Power to postpone distribution

44. Subject to the foregoing provisions of this Act, a personal representative is not bound to distribute the estate of the deceased before the expiration of one year from the death.

PART IV

DISTRIBUTION OF RESIDUARY ESTATE

Abolition of descent to heir, curtesy, dower, and escheat

45.—(1) With regard to the real estate and personal inheritance of every person dying after the commencement of this Act, there shall be abolished—

- (a) All existing modes, rules and canons of descent, and of devolution by special occupancy or otherwise, of real estate, or of a personal inheritance, whether operating by the general law or by the custom of gavelkind or borough English or by any other custom of any county, locality, or manor, or otherwise howsoever; and
 - (b) tenancy by the curtesy and every other estate and interest of a husband in real estate as to which his wife dies intestate, whether arising under the general law or by custom or otherwise; and
 - (c) dower and freebench and every other estate and interest of a wife in real estate as to which her husband dies intestate, whether arising under the general law or by custom or otherwise: Provided that where a right (if any) to freebench or other like right has attached before the commencement of this Act which cannot be barred by a testamentary or other disposition made by the husband, such right shall, unless released, remain in force as an equitable interest; and
 - (d) escheat to the Crown or the Duchy of Lancaster or the Duke of Cornwall or to a mesne lord for want of heirs.
- (2) Nothing in this section affects the descent or devolution of an entailed interest.

Succession to real and personal estate on intestacy

46.—(1) The residuary estate of an intestate shall be distributed in the manner or be held on the trusts mentioned in this section, namely:

- (i) If the intestate leave a husband or wife (with or without issue) the surviving husband or wife shall take the personal chattels absolutely, and in addition the residuary estate of the intestate (other than the personal chattels) shall stand charged with the payment of a net sum of one thousand pounds free of death duties and costs, to the surviving husband or wife with interest thereon from the date of the death at the rate of five pounds per cent. per annum until paid or appropriated, and, subject to providing for that sum and the interest thereon, the residuary estate (other than the personal chattels) shall be held—
 - (a) if the intestate leaves no issue, upon trust for the surviving husband or wife during his or her life;
 - (b) if the intestate leaves issue, upon trust, as to one-half for the surviving husband or wife during his or her life and, subject to such life interest, on the statutory trusts for the issue of the intestate; and, as to the other half, on the statutory trusts for the issue of the intestate, but if those trusts fail or determine in the lifetime of a surviving husband or wife of the intestate, then upon trust for the surviving husband or wife during the residue of his or her life;
- (ii) If the intestate leaves issue but no husband or wife the residuary estate of the intestate shall be held on the statutory trusts for the issue of the intestate;
- (iii) If the intestate leaves no issue but both parents, then, subject to the

interests of a surviving husband or wife, the residuary estate of the intestate shall be held in trust for the father and mother in equal shares absolutely;

- (iv) If the intestate leaves no issue but one parent, then, subject to the interests of a surviving husband or wife, the residuary estate of the intestate shall be held in trust for the surviving father or mother absolutely;
- (v) If the intestate leaves no issue or parent, then, subject to the interest of a surviving husband or wife, the residuary estate of the intestate shall be held in trust for the following persons living at the death of the intestate, and in the following order and manner, namely:

First, on the statutory trusts for the brothers and sisters of the whole blood of the intestate; but if no person takes an absolutely vested interest under such trusts; then

Secondly, on the statutory trusts for the brothers and sisters of the half blood of the intestate; but if no person takes an absolutely vested interest under such trusts; then

Thirdly, for the grandparents of the intestate and, if more than one survive the intestate, in equal shares; but if there is no member of this class; then

Fourthly, on the statutory trusts for the uncles and aunts of the intestate (being brothers or sisters of the whole blood of a parent of the intestate); but if no person takes an absolutely vested interest under such trusts; then

Fifthly, on the statutory trusts for the uncles and aunts of the intestate (being brothers or sisters of the half blood of a parent of the intestate); but if no person takes an absolutely vested interest under such trusts; then

Sixthly, for the surviving husband or wife of the intestate absolutely;

- (vi) In default of any person taking an absolute interest under the foregoing provisions, the residuary estate of the intestate shall belong to the Crown or to the Duchy of Lancaster or to the Duke of Cornwall for the time being, as the case may be, as *bona vacantia*, and in lieu of any right to escheat.

The Crown or the said Duchy or the said Duke may (without prejudice to the powers reserved by Section 9 of the Civil List Act, 1910, or any other powers), out of the whole or any part of the property devolving on them respectively provide, in accordance with the existing practice, for dependants, whether kindred or not, of the intestate, and other persons for whom the intestate might reasonably have been expected to make provision.

- (2) A husband and wife shall for all purposes of distribution or division under the foregoing provisions of this section be treated as two persons.

Statutory trusts in favour of issue and other classes of relative of intestate

47.—(1) Where under this Part of this Act the residuary estate of an intestate, or any part thereof, is directed to be held on the statutory trusts for the issue of the intestate, the same shall be held upon the following trusts, namely:

- (i) In trust, in equal shares if more than one, for all or any the children or child of the intestate, living at the death of the intestate, who attain the age of twenty-one years or marry under that age, and for all or any of the issue living at the death of the intestate who attain the age of twenty-one years or marry under that age of any child of the intestate who predeceases the intestate, such issue to take through all degrees, according to their stocks, in equal shares if more than one, the share which their parent would have taken if living at the death of the intestate, and so that no issue shall take whose parent is living at the death of the intestate and so capable of taking;
- (ii) The statutory power of advancement, and the statutory provisions which relate to maintenance and accumulation of surplus income shall apply, but when an infant marries such infant shall be entitled to give valid receipts for the income of the infant's share or interest;
- (iii) Where the property held on the statutory trusts for issue is divisible into shares, then any money or property which, by way of advancement or on the marriage of a child of the intestate had been paid to such child by the intestate or settled by the intestate for the benefit of such child (including any life or less interest and including property covenanted to be paid or

settled) shall, subject to any contrary intention expressed or appearing from the circumstances of the case, be taken as being so paid or settled in or towards satisfaction of the share of such child or the share which such child would have taken if living at the death of the intestate, and shall be brought into account at a valuation (the value to be reckoned as at the death of the intestate), in accordance with the requirements of the personal representatives;

- (iv) The personal representatives may permit any infant contingently interested to have the use and enjoyment of any personal chattels in such manner and subject to such conditions (if any) as the personal representatives may consider reasonable and without being liable to account for any consequential loss.
- (2) If the trusts in favour of the issue of the intestate fail by reason of no child or other issue attaining an absolutely vested interest—
 - (a) the residuary estate of the intestate and the income thereof and all statutory accumulations, if any, of the income thereof or so much thereof as may not have been paid or applied under any power affecting the same, shall go, devolve and be held under the provisions of this Part of this Act as if the intestate had died without leaving issue living at the death of the intestate;
 - (b) references in this Part of this Act to the intestate 'leaving no issue' shall be construed as 'leaving no issue who attain an absolutely vested interest';
 - (c) references to this Part of this Act to the intestate 'leaving issue' or 'leaving a child or other issue' shall be construed as 'leaving issue who attain an absolutely vested interest'.
- (3) Where under this Part of this Act the residuary estate of an intestate or any part thereof is directed to be held on the statutory trusts for any class of relatives of the intestate, other than issue of the intestate, the same shall be held on trusts corresponding to the statutory trusts for the issue of the intestate (other than the provision for bringing any money or property into account) as if such trusts (other than as aforesaid) were repeated with the substitution of references to the members or member of that class for references to the children or child of the intestate.

Powers of personal representative in respect of interests of surviving spouse

48.—(1) Where a surviving husband or wife is entitled to a life interest in the residuary estate or any part thereof the personal representative may, either with the consent of any such tenant-for-life (not being also the sole personal representative) or, where the tenant-for-life is the sole personal representative, with the leave of the Court, purchase or redeem such life interest (while it is in possession) by paying the capital value thereof (reckoned according to tables selected by the personal representative) to the tenant-for-life or the persons deriving title under him or her and the costs of the transaction, and thereupon the residuary estate of the intestate may be dealt with or distributed free from such life interest.

(2) The personal representatives may raise—

- (a) the net sum of one thousand pounds or any part thereof and the interest thereon payable to the surviving husband or wife of the intestate on the security of the whole or any part of the residuary estate of the intestate (other than the personal chattels), so far as that estate may be sufficient for the purpose or the said sum and interest may not have been satisfied by an appropriation under the statutory power available in that behalf; and
- (b) in like manner the capital sum, if any, required for the purchase or redemption of the life interest of the surviving husband or wife of the intestate, or any part thereof not satisfied by the application for that purpose of any part of the residuary estate of the intestate; and in either case the amount, if any, properly required for the payment of the costs of the transaction.

Application to cases of partial intestacy

49. Where any person dies leaving a will effectively disposing of part of his property, this Part of this Act shall have effect as respects the part of his property not so disposed of subject to the provisions contained in the will and subject to the following modifications:

- (a) The requirements as to bringing property into account shall apply to any beneficial interests acquired by any issue of the deceased under the will of the deceased, but not to beneficial interests so acquired by any other persons;
- (b) The personal representative shall, subject to his rights and powers for the purposes of administration, be a trustee for the persons entitled under this Part of this Act in respect of the part of the estate not expressly disposed of unless it appears by the will that the personal representative is intended to take such part beneficially.

Short title, commencement and extent

58.—(1) This Act may be cited as the Administration of Estates Act, 1925.

(2) This Act shall come into operation on the first day of January, nineteen hundred and twenty-six.

(3) This Act extends to England and Wales only.

FIRST SCHEDULE

PART I

RULES AS TO PAYMENT OF DEBTS WHERE THE ESTATE IS INSOLVENT

1. The funeral, testamentary, and administration expenses have priority.
2. Subject as aforesaid, the same rules shall prevail and be observed as to the respective rights of secured and unsecured creditors and as to debts and liabilities provable and as to the valuation of annuities and future and contingent liabilities respectively, and as to the priorities of debts and liabilities as may be in force for the time being under the law of bankruptcy with respect to the assets of persons adjudged bankrupt.

PART II

ORDER OF APPLICATION OF ASSETS WHERE THE ESTATE IS SOLVENT

1. Property of the deceased undisposed of by will, subject to the retention thereof of a fund sufficient to meet any pecuniary legacies.
2. Property of the deceased not specifically devised or bequeathed but included (either by a specific or general description) in a residuary gift, subject to the retention out of such property of a fund sufficient to meet any pecuniary legacies, so far as not provided for as aforesaid.
3. Property of the deceased specifically appropriated or devised or bequeathed (either by a specific or general description) for the payment of debts.
4. Property of the deceased charged with, or devised or bequeathed (either by a specific or general description) subject to a charge for the payment of debts.
5. The fund, if any, retained to meet pecuniary legacies.
6. Property specifically devised or bequeathed, rateably according to value.
7. Property appointed by will under a general power, including the statutory power to dispose of entailed interests, rateably according to value.
8. The following provisions shall also apply—
 - (a) The order of application may be varied by the will of the deceased.
 - (b) This Part of this Schedule does not affect the liability of land to answer the death duty imposed thereon in exoneration of other assets.

HOSPITAL

GENERAL INCOME AND

For the year ended

<i>Expenditure</i>	(£'s only)	(£'s only)
DIRECT OR BASIC SERVICES:		
Wards	93,746	
Out-Patient and Casualty Departments	12,432	
Diagnostic X-Rays	10,421	
Theatres	3,792	
Laboratory Services	5,637	
Dispensary	3,814	
Mortuary and Post Mortem Room	1,871	
Social Service and Almoner's Department	2,479	
Patients' Registration Office	2,718	
Patients' Library	314	
Medical Records and Follow-up Office	1,487	
		138,711
INDIRECT SERVICES:		
Administrative Office	10,737	
Matron's Office	5,319	
Medical Superintendent's Office	8,314	
Works Superintendent's Office	2,319	
Stores Control	1,721	
Kitchens	7,318	
Dining Rooms	3,129	
Medical Officers' Residence	1,374	
Nurses' Home	12,591	
Maid's Home	4,350	
Gardens	758	
Training School—Nursing	10,758	
Midwifery	3,115	
Radiography	1,978	
Physiotherapy	8,417	
Heating, Lighting, Water and Rates	48,173	
Cleaning (excluding Annual Painting and Cleaning)	15,132	
Laundry	10,322	
General Services	18,143	
		173,968
ANCILLARY AND AUXILIARY SERVICES:		
Domiciliary Midwifery	8,374	
District Nursing	1,429	
Radium and X-Ray Therapy	6,719	
Physiotherapy	7,342	
Dental	16,219	
V.D. Clinic	14,914	
Farm and Garden	—	
Estate	—	
Canteen and Shop	—	
Diversional Therapy	262	
Occupational Therapy	—	
		55,259
TOTAL EXPENDITURE		367,938
Balance, representing excess of Income over Expenditure, due to the Ministry of Health		6,216
		£374,154

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SMALL INSTITUTIONS

.....HOSPITAL
GENERAL INCOME AND EXPENDITURE ACCOUNT
For the year ended, 31st March, 19.....

<i>Expenditure</i>		<i>Income</i>	
	(£'s only)		(£'s only)
DIRECT OR BASIC SERVICES:		SUPPLIES FROM CENTRAL STORES	
Wards, Out-Patients, Casualty and Theatres ..	5,591	SERVICES RENDERED	572
Diagnostic X-Rays	738	PATIENTS	249
Laboratory, Dispensary and Mortuary Services ..	173	GENERAL:	721
Patients' Records and Almoner's Office	485	Fees from Students—	
		Physiotherapy .. .. .	..
INDIRECT SERVICES:		Radiotherapy .. .. .	..
Administration	1,758	Farm and Garden .. .. .	..
Stores Control, Kitchens, Medical Officers' Resi-		Estate .. .. .	..
dence, Nurses' and Maids' Homes	3,419	Canteen and Shop	56
Gardens	47	Diversional Therapy .. .. .	..
Heating, Lighting, Water and Rates	4,231	Occupational Therapy .. .. .	..
Cleaning (including Annual Painting and Cleaning)	248	Staff Payments for Accommodation	27
Laundry	821	Cash Discount .. .. .	..
General Services	472	Gifts in kind	93
	
ANCILLARY AND AUXILIARY SERVICES:		.....	..
Domiciliary Midwifery	932	.....	..
District Nursing .. .. .	—	.....	..
Radium and X-Ray Therapy .. .. .	—	.....	..
Physiotherapy	421	.....	..
Dental .. .. .	—	.....	..
V.D. Clinic .. .. .	—	.....	..
Farm and Garden .. .. .	—	.....	..
Estate .. .. .	—	.....	..
Canteen and Shop .. .. .	—	.....	..
Diversional Therapy .. .. .	—	.....	..
Occupational Therapy .. .. .	—	.....	..
	
TOTAL EXPENDITURE	19,336	OTHER GOVERNMENT DEPARTMENTS	
Balance, representing excess of Income over Expendi-		CONTRIBUTION FROM THE MINISTRY OF HEALTH for	
ture, due to the Ministry of Health		the year, on account of General Maintenance ..	17,000
		TOTAL INCOME	18,718
		Balance, representing excess of Expenditure over	
		Income, due from the Ministry of Health	618
			£19,336

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BALANCE SHEET as at 31st March 19.....

Liabilities		£	£	£	Assets		£	£	£
ENDOWMENT FUND:					ENDOWMENT FUND:				
<i>Capital Account</i> as at 1st April, 19.....		57,425			<i>Investment Account—</i>		62,813		
<i>Add</i> Donations and Legacies received during the year		5,650	63,075		Investments at cost		462		
<i>Revenue Account—</i>					Cash in Bank		—		63,075
Sundry Creditors		521			Cash in hand		—		
Unexpended income balance		149			<i>Revenue Account—</i>		75		
			670		Sundry Debtors		575		
					Cash at Bank		20		670
SPECIAL TRUST FUNDS:					SPECIAL TRUST FUNDS:				
<i>Capital Accounts—</i>					<i>Investment Account—</i>		10,974		
Nurses' Prize Fund		250	10,974		Investments at cost		—		10,974
Johnson Scholarship Fund		10,724			Cash at Bank		—		
<i>Revenue Account—</i>		5			Cash in hand		—		
Sundry Creditors		254	259		<i>Revenue Account—</i>		37		
Unexpended income balances					Sundry Debtors		222		
LAND, BUILDINGS AND EQUIPMENT FUND:					Cash at Bank		—		259
Contributions from 8th July, 1946		17,000	31,802		Cash in hand		—		
<i>Add</i> Grants received during year		14,862	790		LAND, BUILDINGS AND EQUIPMENT FUND:		17,647		11,233
Sundry Creditors					Expenditure to 1st April, 19		13,479		
SPECIAL PURPOSES FUND:					<i>Add</i> Expenditure incurred during year				
Sundry Creditors		321	321		Sundry Debtors		31,126		
Unexpended income balances		993	993		Cash at Bank		117		
GENERAL FUND:					Cash in hand		1,542		
<i>Sundry Creditors—</i>					SPECIAL PURPOSES FUND:		7		32,592
Trade		26,661	1,314		Sundry Debtors		—		
Others		2,524			Cash at Bank		1,291		
<i>Reserves on Account of—</i>					Cash in hand		23		1,314
Private Patients		1,000	29,185		GENERAL FUND:				
Occupational Therapy		650	1,650		Sundry Debtors		1,847		
MINISTRY OF HEALTH:					Stocks on hand—				
Balance brought forward 1st April, 19		2,134			Unissued Stores		15,062		
<i>Add</i> Excess of income over expenditure for the year as per General Income and Expenditure Account		6,216	8,350		Farm and Garden		5,788		
					Lantien and Shop		289		
					Divisional Therapy		98		
					Occupational Therapy		428		
						
					Cash at Bank		21,616		
					Cash in hand		15,479		
							243		
									39,185
									£148,069

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.....HOSPITAL

PRIVATE PATIENTS

INCOME AND EXPENDITURE ACCOUNT

For the year ended 31st March, 19.....

<i>Expenditure</i>				<i>Income</i>			
	£	s	d		£	s	d
To DIRECT CHARGES:				By Maintenance Fees	21,364	7	0
Salaries and Wages—				„ Other Revenue (to be specified):			
Medical .. £1,751	11	3		Physiotherapy Fees ..	521	8	0
Nursing .. 3,419	12	3		Diagnostic X-Ray Fees ..	720	0	0
Other Officers 6,721	14	7					
	11,892	18	1				
Uniforms	131	14	2				
Provisions	1,172	3	9				
Drugs, Chemicals, Dressings, Instruments and Appliances	924	13	8				
Renewals and Repairs:							
Bedding, Linen, Furniture, Hardware, Crockery, &c.	329	0	5				
Cleaning Materials	172	13	4				
Laundry	451	18	6				
Structural Repairs	741	4	11				
Annual Cleaning and Repainting	375	9	5				
Printing, Stationery, Postages, Telephones, &c.	131	7	9				
„ INDIRECT CHARGES:							
Administrative Office	250	0	0				
Matron's Office	243	1	9				
Medical Superintendent's Office	289	13	2				
Works Superintendent's Office	73	2	4				
Stores Control	71	13	2				
Kitchens	217	9	4				
Dining Rooms	25	4	9				
Medical Officers' Residence ..	78	2	9				
Nurses' Home	75	3	1				
Maids' Home	31	4	7				
Garden	10	0	0				
Heating, Lighting, Water and Rates	527	3	11				
Cleaning	91	3	4				
General Services	83	2	9				
TOTAL	18,689	8	11	TOTAL	22,605	15	0
„ Balance, being surplus transferred to Appropriation Account ..	3,916	6	1				
	£22,605	15	0				
					£22,605	15	0

APPROPRIATION ACCOUNT

	£	s	d		£	s	d
To Expenditure on:				By Balance brought down ..	3,916	6	1
.....							
„ Reserves carried forward on ac- count of:				„ Reserves brought forward on ac- count of:			
Replacement of Diagnostic X-Rays Apparatus ..	1,000	0	0	.....		
.....						
TOTAL	1,000	0	0	TOTAL	3,916	6	1
„ Balance, being net surplus trans- ferred to General Income and Expenditure Account ..	2,916	6	1				
	£3,916	6	1				
					£3,916	6	1

.....HOSPITAL

STATISTICAL TABLE

Showing unit cost of each department for the year ended 31st March, 19.....

DEPARTMENT	TOTAL			UNIT STANDARD (4)	Total No. of units for year (5)	Average cost per unit (Col. 1 divided by Col. 5)
	Gross Expendi- ture (1)	Offsets against Expendi- ture (2)	Net Expendi- ture (3)			
DIRECT OR BASIC SERVICES:						
Wards				Ward Patient Day ..		
O.P. and Cas. Dept. ..				Attendance		
Diagnostic X-Ray				Attendance		
Theatres				Operation		
Lab. Services				Specimen		
Dispensary				100 Prescriptions ..		
Mortuary and P.M. Room				In-patient Day ..		
Social Service and Almoner's Dept.				Case		
Patient's Registration Office				Case		
Patients' Library				In-patient Day ..		
Medical Records and Follow- up Office				In-patient Day ..		
INDIRECT SERVICES:						
Admin. Office				Head of all staff ..		
Matron's Office				Head of nursing and domestic staff ..		
Medical Supt.'s Office ..				Patient Day		
Works Supt.'s Office ..				Head of Works Staff		
Stores Control				In-patient Day ..		
Kitchens				Head of staff and patients fed ..		
Dining Rooms				Head of staff fed ..		
Medical Officers' Residence				Resident Week ..		
Nurses' Home				Resident Week ..		
Maids' Home				Resident Week ..		
Gardens				Patient Day		
Training Schools—						
Nursing				Student Week ..		
Midwifery				Student Week ..		
Radiography				Student Week ..		
Physiotherapy				Student Week ..		
Heating, Lighting, Water Rates				Patient Day		
Cleaning (excluding Annual Painting and Cleaning) ..				Patient Day		
Laundry				1,000 articles		
General Services				Patient Day		
ANCILLARY AND AUXILIARY SERVICES:						
Domiciliary Midwifery ..				Case		
District Nursing				Case		
Radium and X-Ray Therapy				Attendance		
Physiotherapy				Attendance		
Dental				Attendance		
V.D. Clinic				Attendance		

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BUILDING SOCIETIES' ACCOUNTS**THE BUILDING SOCIETIES ACT, 1874***37 & 38 Vict. Ch. 42*

13. Any number of persons may establish a society under this Act, either terminating or permanent, for the purpose of raising by the subscriptions of the members a stock or fund for making advances to members out of the funds of the society, upon security of freehold, copyhold, or leasehold estate, by way of mortgage; and any society under this Act shall, so far as it is necessary for the said purpose, have power to hold land with the right of foreclosure, and may from time to time raise funds by the issues of shares of one or more denominations, either paid up in full, or to be paid by periodical or other subscriptions, and with or without accumulating interest, and may repay such fund, when no longer required for the purposes of the society: Provided always, that any land to which any such society may become absolutely entitled by foreclosure, or by surrender, or other extinguishment of the right of redemption, shall as soon afterwards as may be conveniently practicable be sold or converted into money.

14. The liability of any member of any society under this Act in respect of any share upon which no advance has been made shall be limited to the amount actually paid or in arrear on such share, and in respect of any share upon which an advance has been made shall be limited to the amount payable thereon under any mortgage or other security, or under the rules of the society.

Power to borrow

15. With respect to the borrowing of money by societies under this Act, the following provisions shall have effect:

- (1) Any society under this Act may receive deposits or loans at interest within the limits of this section provided, from the members or other persons, or from corporate bodies, joint-stock companies or from any terminating building society to be applied to the purposes of the society;
- (2) In a permanent society the total amount so received on deposit or loan and not repaid by the society shall not at any time exceed two-thirds of the amount for the time being secured to the society by mortgages from its members;
- (3) In a terminating society the total amount so received and not repaid may either be a sum not exceeding such two-thirds as aforesaid, or a sum not exceeding twelve months' subscriptions on the shares for the time being in force;
- (4) Any deposits with or loans to a society under this Act made before the commencement of this Act in accordance with its certified rules are hereby declared to be valid and binding on the society, but no further deposits or loans shall be received by such society, except within the limits provided by this section;
- (5) Every deposit book or acknowledgement or security of any kind given for a deposit or loan by a society shall have printed or written therein or thereon the whole of the fourteenth and fifteenth sections of the present Act.

What rules must provide

16. The rules of every society hereafter established under this Act shall set forth—

- (6) The manner of appointing, remunerating, and removing the board of directors or committee of management, auditors, and other officers;
- (8) Provision for an annual or more frequent audit of the accounts, and inspection by the auditors of the mortgages and other securities belonging to the society.

Investment of surplus funds

25. Any society under this Act may from time to time, as the rules permit, invest any portion of the funds of the society not immediately required for its purposes, upon real or leasehold securities, or in the public funds, or in or upon any Parliamentary stock or securities, or in or upon any stock or securities

payment of the interest on which is guaranteed by authority of Parliament, or in the case of terminating societies, with other societies under this Act; and for the purpose of investments in the public funds or upon security of copyhold or customary estate, the society, or the board of directors and committee of management thereof, may from time to time appoint and remove trustees.

Decease of member or depositor intestate

29. If any member of or depositor with a society under this Act, having in the funds thereof a sum of money not exceeding fifty pounds, shall die intestate, then the amount due may be paid to the person who shall appear to the directors or committee of management of the society to be entitled under the Statute of Distributions to receive the same, without taking out letters of administration, upon the society receiving satisfactory evidence of death and a statutory declaration that the member or depositor died intestate, and that the person so claiming is entitled as aforesaid: Provided that, whenever the society after the decease of any member or depositor has paid any such sum of money to the person who at the time appeared to be entitled to the effects of the deceased, under the belief that he had died intestate, the payment shall be valid and effectual with respect to any demand from any other person as next-of-kin or as the lawful representative of such deceased member or depositor against the funds of the society, but, nevertheless, such next-of-kin or representative shall have his lawful remedy for the amount of such payment as aforesaid against the person who has received the same.

Annual accounts

40. The secretary or other officer of every society under this Act shall, once in every year at least, prepare an account of all the receipts and expenditure of the society since the preceding statement, and a general statement of its funds and effects, liabilities and assets, showing the amounts due to the holders of the various classes of shares respectively, to depositors and creditors for loans, and also the balance due or outstanding on their mortgage securities (not including prospective interest), and the amount invested in the funds or other securities; and every such account and statement shall be attested by the auditors to whom the mortgage deeds and other securities belonging to the society shall be produced, and such account and statement shall be countersigned by the secretary or other officer; and every member depositor, and creditor for loans shall be entitled to receive from the society a copy of such account and statement, and a copy thereof shall be sent to the Registrar within fourteen days after the annual or other general meeting at which it is presented, and another copy thereof shall be suspended in a conspicuous place in every office of the society under this Act.

THE BUILDING SOCIETIES ACT, 1894

57 & 58 Vict. Ch. 47

Matters to be set forth in rules

1. The rules of every society under the Building Societies Acts established or substituting a new set of rules for its existing rules after the passing of this Act shall be set forth—

- (a) The manner in which the stock or funds of the society is or are to be raised;
- (b) The terms upon which unadvanced subscription shares are to be issued; the manner in which the contributions are to be paid to the society, and withdrawn by the members, with tables, where applicable in the opinion of the Registrar, showing the amount due by the society for principal and interest separately;
- (c) The terms upon which paid-up shares if any are to be issued and withdrawn, with tables, where applicable in the opinion of the Registrar, showing the amount due by the society for principal and interest separately;
- (d) Whether preferential shares are to be issued, and, if so, within what limits;
- (e) The manner in which advances are to be made and repaid; the deductions,

if any, for premiums, and the conditions upon which a borrower can redeem the amount due from him before the expiration of the period for which the advance was made, with tables, where applicable in the opinion of the Registrar, showing the amount due from the borrower after each stipulated payment;

- (f) The manner in which losses are to be ascertained and provided for;
- (g) The manner in which membership is to cease; and
- (h) Whether the society intends to borrow money, and, if so, within what limits not exceeding those prescribed by the Building Societies Acts.

Annual accounts

2.—(1) Every annual account and statement under Section 40 of the Building Societies Act, 1874, shall be made up to the end of the official year of the society to which it relates, and shall be in such form and shall contain such particulars as the Chief Registrar of Friendly Societies may from time to time, with the approval of a Secretary of State, direct, either generally or with respect to any society or class of societies. The form of annual account and statement prescribed for general use by the Chief Registrar under this section, and every alteration of that form shall, as soon as practicable, be laid before each House of Parliament, and shall not come into operation until the expiration of forty days from the date at which it is so laid. Provided that every such account and statement shall set forth—

- (a) With respect to mortgages to the society upon each of which the present debt does not exceed five thousand pounds (not being mortgages where the repayments are upwards of twelve months in arrear, or where the property has for upwards of twelve months been in possession of the society), the number of all such mortgages, and the aggregate amount owing thereon at the date of the account or statement, such information being given separately in respect of each of the four following classes:
 - (i) where the debt does not exceed five hundred pounds;
 - (ii) where the debt exceeds five hundred pounds and does not exceed one thousand pounds;
 - (iii) where the debt exceeds one thousand pounds and does not exceed three thousand pounds;
 - (iv) where the debt exceeds three thousand pounds and does not exceed five thousand pounds; and
- (b) With respect to any other mortgage to the society, the particulars shown by the appropriate tabular form in the First Schedule to this Act.
- (2) Every auditor, in attesting any such annual account or statement, shall either certify that it is correct, duly vouched, and in accordance with law, or specially report to the society in what respects he finds it incorrect, unvouched, or not in accordance with law, and shall also certify that he has at that audit actually inspected the mortgage deeds and other securities belonging to the society, and shall state the number of properties with respect to which deeds have been produced to and actually inspected by him.
- (3) A copy of every such annual account and statement shall be sent to the Registrar within fourteen days after the annual or other general meeting at which it is presented, or within three months after the expiration of the official year of the society, whichever period expires first.
- (4) For the purposes of this section the expression 'official year' shall mean, in the case of any society established after the passing of this Act, the year ending with the thirty-first day of December; and in the case of any society established before the passing of this Act, the year ending with the time up to which its annual account and statement is made at the passing of this Act.
- (5) This section shall not come into operation until the expiration of twelve months after the passing of this Act.

Auditors

3. Notwithstanding anything in the rules of any society under the Building Societies Acts, one at least of the auditors of the society shall be a person who publicly carries on the business of an accountant.

Dissolution

11. If a society under the Building Societies Acts is dissolved in manner prescribed by its rules or in pursuance of the consent of three-fourths of the members, the liquidators, trustees, or other persons having the conduct of the dissolution shall, within twenty-eight days from the termination of the dissolution, send to the Registrar an account and balance sheet signed and certified by them as correct, and showing the assets and liabilities of the society at the commencement of the dissolution, and the mode in which those assets and liabilities have been applied and discharged; and in default of so doing shall each be liable to a fine not exceeding five pounds for every day during which the default continues.

Prohibition of advances

13.—(1) A society under the Building Societies Acts shall not advance money on the security of any freehold, copyhold, or leasehold estate which is subject to a prior mortgage, unless the prior mortgage is in favour of the society making the advance.

(2) Provided that this section shall not apply to any society in Scotland or Ireland which is at the passing of this Act authorised by the rules to make advances upon second mortgage.

(3) If any advance is made in contravention of this section, the directors of the society who authorised the advance shall be jointly and severally liable for any loss on the advance occasioned to the society.

Borrowing powers, &c.

14. In calculating the amount for the time being secured to a society under the Building Societies Acts by mortgages from its members for the purpose of ascertaining the limits of its power to receive deposits or loans at interest, the amount secured on properties the payments in respect of which were upwards of twelve months in arrear at the date of the society's last preceding annual account and statement, and the amount secured on properties of which the society had been twelve months in possession at the date of such account and statement, shall be disregarded.

Provided that this section shall not affect the validity of any deposit or loan which was within the limit provided by law at the time when it was received, and so far as regards any amount secured either on properties the payments in respect of which are upwards of twelve months in arrear at the passing of this Act, or on properties in the possession of the society at the passing of this Act, shall not come into operation until the expiration of three years from the passing of this Act.

15.—(1) A society under the Building Societies Acts shall not use any name or title other than its registered name, and shall not accept any deposit except on the terms that not less than one month's notice may be required by the managers of the society before repayment or withdrawal.

(2) If a society contravenes this section, the society and also every director or member of the committee of management who is a party to the contravention, shall be liable, on summary conviction, to a fine not exceeding ten pounds, and, in the case of a continuing offence, to an additional fine not exceeding ten pounds, for every week during which the offence continues.

16.*—(1) A society under the Building Societies Acts may—

(a) Deposit in a savings bank any money belonging to the society; and

(b) Invest in Government stock through a savings bank any money of the society.

(5) In this section the expressions 'savings bank' and 'Government stock' have respectively the same meaning as in the Savings Bank Act, 1893.

Power of investment

17. The powers of investment under Section 25 of the Building Societies Act, 1874, shall include power to invest in or upon any security in which trustees are for the time being authorised by law to invest.

* An amendment made by the Savings Bank Act, 1920, has here been given effect to.—Ed.

Penalties

21. If any society under the Building Societies Acts neglects or refuses—

- (a) To give any notice, send any return or document, or do or allow to be done anything which the society is by those Acts required to give, send, do or allow to be done; or
- (b) To do any act or furnish any information required for the purposes of those Acts by the Registrar or by any inspector; the society and also every officer thereof bound by the rules thereof to fulfil the duty whereof a breach has been so committed and if there is no such officer, then every member of the committee of management or board of directors of the society, unless it appears that he was ignorant of or attempted to prevent the breach, shall for each offence be liable, on summary conviction, to a fine not exceeding twenty pounds, and, in the case of a continuing offence, to an additional fine not exceeding five pounds for every week during which the offence continues.

Illicit bonuses, &c.

23. No director, secretary, surveyor, solicitor, or other officer of a society under the Building Societies Acts shall, in addition to the remuneration prescribed or authorised by the rules of the society, receive from any other person any gift, bonus, commission, or benefit, for or in connection with any loan made by the society, and any person paying or accepting any such gift, bonus, commission, or benefit, shall be liable, on summary conviction, to a fine not exceeding fifty pounds, and, in default of payment, to be imprisoned with or without hard labour for any time not exceeding six months, and the person accepting any such gift, bonus, commission, or benefit shall, as and when directed by the Court by whom he is convicted, pay over to the society the amount or value of such gift, bonus, commission, or benefit, and in default of such payment shall be liable to be imprisoned with or without hard labour for any time not exceeding six months.

Application of 1874 Act

25.—(1) Section 40 of the Building Societies Act, 1874, shall apply to every society which has been certified under the Building Societies Act, 1836 (that is to say, the Act of the session held in the sixth and seventh year of King William the Fourth, chapter 32, intituled 'An Act for the regulation of Benefit Building societies'), and has not been incorporated under the Building Societies Act, 1874, and exists at the passing of this Act, and if any such society fails to comply with the requirements of that section, the society and its members and officers shall be subject to the like penalties as if the society were a society under the Building Societies Acts.

(2) On the expiration of two years from the passing of this Act, the said Building Societies Act, 1836, shall be repealed as to all societies certified thereunder after the year one thousand eight hundred and fifty-six.

Forms

26. The forms in the Third Schedule to this Act shall, after the commencement of this Act, be used under the Building Societies Acts.

BUILDING SOCIETIES ACTS, 1874-1940

ANNUAL ACCOUNT AND STATEMENT for year ended.....19.....

The account and statement to be presented to the annual or other general meeting and copies supplied to members and others must be identical with the copy sent to the Registrar, except that any account or item may be omitted if the entry would be 'nil' or if the omission is authorised by a footnote. Instructional words printed in italics may also be omitted.

The account and statement, together with any special report of the auditors, must be sent to the Registrar within fourteen days after it has been presented to a general meeting or within three months after the expiration of the official year of the society, whichever period expires first.

Name of society.....

Registered Office.....

Date of Incorporation.....

Number of share investors at end of year.....

Number of depositors and loanholders at end of year.....

Number of borrowers at end of year.....

NAMES AND ADDRESSES* OF DIRECTORS, &C., AT THE DATE UP TO WHICH THE
ACCOUNT AND STATEMENT IS MADE

	<i>Name</i>	<i>Address*</i>
Directors or Committee of Management		
Secretary		

*Addresses may be omitted from copies of the account and statement

Dr.

1. SHARES ACCOUNT

Cr.

	£	s	d		£	s	d
Withdrawals, including Interest, Dividend and Bonus <i>(Other Debits (to be Specified):</i>				Subscriptions Interest, Dividend and Bonus <i>Other Credits (to be specified):</i>			
.....						
.....						
.....						
.....						
.....						
.....						
.....						
.....						
.....						
Due to Shareholders at end of year				Due to Shareholders at beginning of year			
TOTAL	£			TOTAL	£		

2. DEPOSITS AND LOANS ACCOUNT*

	£	s	d		£	s	d
Deposits and Loans repaid or withdrawn, including Interest				Deposits and Loans			
Other Debits (to be specified):				Interest			
.....				Other Credits (to be specified):			
.....						
.....						
.....						
.....						
.....						
Due on Deposits and Loans at end of year				Due on Deposits and Loans at beginning of year			
Total				Total			
Loans from Bank repaid, including Interest (or reduction in Overdrafts)				Loans from Bank (or increase in Overdrafts)			
Due to Bank on Loans and Overdrafts at end of year				Interest			
				Due to Bank on Loans and Overdrafts at beginning of year			
TOTAL	£			TOTAL	£		

* Transactions in respect of bank loans and overdrafts should be excluded from the figures inserted in the first section of this account.

Dr.

3. MORTGAGES ACCOUNT

Cr.

	£	s	d		£	s	d
Advanced on Mortgage:				Repayments of Advances and Interest			
On Mortgages where the advance agreed to will not exceed £2,000				Losses on realisation:			
On Mortgages where the advance agreed to will exceed £2,000				Charged to Account No. 5 ..			
				Charged to Account No.			
Total				Insurance Premiums			
Interest				*Survey Fees and Expenses ..			
Insurance Premiums				Other Credits (to be specified):			
*Survey Fees and Expenses			
Other Debits (to be specified):						
.....						
.....						
.....						
.....						
Due on Mortgages at beginning of year				Due on Mortgages at end of year			
Total	£				£		

*These headings do not apply if the items are shown in Account No. 5.

4. INVESTMENTS ACCOUNT

	f	s	d		f	s	d
Investments made:				Investments realised:			
British Government Securities				British Government Securities			
Colonial and Dominion Securities				Colonial and Dominion Securities			
British Municipal and County Securities				British Municipal and County Securities			
Other Investments (to be specified):				Other Investments (to be specified):			
.....						
.....						
.....						
.....						
.....						
.....						
.....						
.....						
.....						
.....						
.....						
.....						
Profits on realisation of Investments (as per Account No.....)				Losses on realisation of Investments (as per Account No.....)			
Interest and Dividends (as per Account No. 5)				Depreciation of Investments (as per Account No.)			
Total				Interest and Dividends received			
Balance at beginning of year .				Total			
TOTAL	f			Balance at end of year			
				TOTAL	f		

Dr.

5. PROFIT AND LOSS ACCOUNT

Cr.

<i>Expenditure</i>	<i>£ s d</i>	<i>Income</i>	<i>£ s d</i>
Management Expenses:		Interest from Borrowers ..	
Directors' Fees ..		Interest and Dividends from Investments ..	
Remuneration of Staff and Auditors ..		Bank Interest ..	
Rents, Rates, Insurance, Heat, Light, Cleaning, Repairs, etc. (Offices) ..		Rents, etc., from letting of office premises ..	
Printing, Stationery and Postages ..		*Survey Fees and Expenses ..	
Advertising Commission and Agency Fees ..		Other Fees, Fines, Rules and Pass Books ..	
<i>Other Expenses (to be specified):</i>		Commission (Fire, Life, etc., Insurance)	
.....		<i>Other Income (to be specified):</i>	
.....		
.....		
.....		
.....		
Total Management Expenses	
*Survey Fees and Expenses	
Interest on Deposits and Loans (other than Loans from Bank)		
Interest on Loans and Overdrafts from Bank	
†Income Tax	
Losses on Mortgages as per Account No. 3	
Depreciation:		
Office Premises, Furniture, etc.		
Other Assets	
<i>Other Expenditure (to be specified):</i>		
.....		
.....		
Balance carried to Appropriation Account ..		Balance (Loss) carried to Appropriation Account ..	
TOTAL	£	TOTAL	£

* These headings do not apply if the items are shown in Account No. 3.

† Excluding tax on directors' fees and remuneration of staff which must be included in the fees and remuneration above.

6. APPROPRIATION ACCOUNT

	£	s	d		£	s	d
Balance (Loss) brought forward from last year ..				Balance brought forward from last year ..			
Balance (Loss) from Profit and Loss Account ..				Balance from Profit and Loss Account ..			
Losses on realisation of Investments ..				Profits on realisation of Investments ..			
Other capital losses (to be specified): ..				Other capital profits (to be specified): ..			
Interest, Dividend and Bonus to Shareholders			
Other appropriations (to be specified):			
.....						
Balance carried forward ..				Balance (Loss) carried forward ..			
TOTAL	£			TOTAL	£		

Dr. 7. GENERAL RESERVE ACCOUNT Cr.

	£	s	d		£	s	d
Debits (to be specified): ..				Appropriations from Account No. 6 ..			
.....				Other Credits (to be specified): ..			
.....						
Total				Total			
Balance at end of year ..				Balance at beginning of year ..			
TOTAL	£			TOTAL	£		

OTHER RESERVE ACCOUNTS

7(a).

ACCOUNT

	£	s	d		£	s	d
.....						
.....						
Total				Total			
Balance at end of year ..				Balance at beginning of year ..			
TOTAL	£			TOTAL	£		

7(b).

ACCOUNT

	£	s	d		£	s	d
.....						
.....						
Total				Total			
Balance at end of year ..				Balance at beginning of year ..			
TOTAL	£			TOTAL	£		

7(c).....ACCOUNT

	£	s	d		£	s	d
.....						
.....						
Total				Total			
Balance at end of year ..				Balance at beginning of year ..			
TOTAL	£			TOTAL	£		

SHEET

Assets

s d

*BALANCE DUE OR OUTSTANDING ON MORTGAGES, not including prospective interest:
Mortgages from Members where the repayments are not upwards of 12 months in arrear and the property has not been upwards of 12 months in possession of the Society:

On Mortgages where the debt does not exceed £500
On Mortgages where the debt exceeds £500 and does not exceed £1,000
On Mortgages where the debt exceeds £1,000 and does not exceed £3,000
On Mortgages where the debt exceeds £3,000 and does not exceed £5,000
On Mortgages where the debt exceeds £5,000, as shown by Part I of the Schedule

†Total (A)

(If the Society has any Mortgages from non-members, the like particulars as above are to be given in full for all such Mortgages.)

Balance as shown in Parts II and III of Schedule:

On Mortgages on Property of which the Society has been upwards of 12 months in possession, as shown by Part II of the Schedule (present amount included in assets)
On Mortgages where the repayments are upwards of 12 months in arrear, and the property has not been upwards of 12 months in possession of the Society, as shown by Part III of the Schedule (present debt)

Total (as per Account No. 3) ..

Total number of MORTGAGES..... .. .

Market Value at date of Balance Sheet

INVESTMENTS:

British Government Securities ..
Colonial and Dominion Securities ..
British Municipal and County Securities ..
Other Investments (to be specified):

Interest Accrued

Total (as per Account No. 4) ..

OTHER ASSETS (to be specified):

Office Premises
Cash at Bank and in Hand

BALANCE (LOSS) CARRIED FORWARD (as per Account No. 6) ..

TOTAL ..

*The actual amounts due from borrowers, without any deduction by way of provision for anticipated losses, must be shown under this head except in the case of Properties included in Part II of the Schedule.

† See Note at end of Part III of Schedule.

SCHEDULE

PART I

PARTICULARS to be set forth in the case of every mortgage where the repayments are not upwards of twelve months in arrear, and the property has not been upwards of twelve months in the possession of the society, and where the present debt exceeds £5,000.

1 Date of Advance	2 Whether subject to any prior Mortgage or Charge. If so, what amount?	3 Whether Freehold, Copyhold, or Leasehold	4 Original Valuation of Property	5 Amount of Advance	6 * Present Debt	7 Amount of Payments in Advance	8 Amount of Payments in Arrear	9 Observations
			£	£	£	£	£	
		Total						

* When the Mortgagor is not a member of the Society, an asterisk is to be placed against the amount of present debt.

PART II

PARTICULARS to be set forth in the case of property of which the society has been upwards of twelve months in possession.

1 Roll Numbers	2 Date of Advance	3 Date when Possession was taken	4 Whether subject to any prior Mortgage or Charge. If so, what amount?	5 Whether Freehold, Copyhold, or Leasehold	6 Amount of Advance	7 Original Valuation of Property	8 Debt when Possession was taken	9 Present Amount included in Assets	10 Gross Income for the Year	11 Outgoings for the Year	12 Observations
					£	£	£	£	£	£	
				Total							

PART III

PARTICULARS to be set forth in the case of every mortgage where the repayments are upwards of twelve months in arrear and the property has not been upwards of twelve months in the possession of the society.

Date of Advance 1	Whether subject to any prior Mortgage or Charge. If so, what amount? 2	Whether Freehold, Copyhold, or Leasehold 3	Number of Months in Arrear 4	Original Valuation of Property 5	Amount of Advance 6	Present Debt 7	Amount of Payments in Arrear 8	Observations 9
				£	£	£	£	
			Total					

Note.—The amount shown in the Balance Sheet against 'Total (A)' includes £ : : outstanding on Mortgages where the Payments of Interest but not the Repayments of Principal are upwards of Twelve Months in Arrear. (If there is no amount included in 'Total (A)' in respect of such mortgages, this note and the words 'Total (A)' in the Balance Sheet should be struck out.)

Signature of Secretary.....

The undersigned, having examined the foregoing Annual Account and Statement, hereby certify that it is correct, duly vouched, and in accordance with law (subject to a Special Report dated the day of)*.

We further certify that we have at this audit actually inspected the Mortgage Deeds in respect of each of the Properties in mortgage to the Society and the other Securities belonging to the Society, referred to in the foregoing Account and Statement.

Signature of Auditor..... Signature of Auditor.....

Address at which business is publicly carried on as an Accountant { Address.....
.....
.....

I hereby certify that the foregoing is a true copy of the Account and Statement presented to a general meeting of the Society on day of, 19..... and adopted.

Signature of Chairman.....

* If no special report is made the words in brackets should be struck out. The auditors must make a special report if in any respect the annual account and statement is incorrect, unvouched or not in accordance with law. A copy of any such special report must be sent to the registrar with the annual account and statement.

FRIENDLY SOCIETIES ACT, 1896

59 & 60 Vict. Ch. 25

Appointment of trustees

25.—(1) Every registered society and branch shall have one or more trustees.

(4) The same person shall not be secretary or treasurer of a registered society or branch and a trustee of that society or branch.

Audit

26.*—(1) Every registered society and branch shall once at least in every year submit its accounts for audit either to one of the approved auditors appointed as in this Act mentioned, or to two or more persons appointed as the rules of the Society or branch provide.

(2) The auditors shall have access to all the books and accounts of the society or branch, and shall examine the annual return mentioned in this Act, and verify the annual return with the accounts and vouchers relating thereto, and shall either sign the annual return as found by them to be correct, duly vouched, and in accordance with law, or specially report to the society or branch in what respects they find it incorrect, unvouched, or not in accordance with law.

Annual returns

27.—(1) Every registered society and branch shall once in every year, not later than the 31st day of May, send to the Registrar a return (in this Act called the annual return) of the receipts and expenditure, funds, and effects of the society or branch as audited.

(2) The annual return must—

(a) show separately the expenditure in respect of the several objects of the society or branch; and

(b) be made out to the 31st day of December then last inclusively; and

(c) state whether the audit has been conducted by an approved auditor appointed as by this Act provided, and by whom, and, if by persons other than an approved auditor, state the name, address, and calling or profession of every such person, and the manner in which, and the authority under which, he is appointed.

(3) The society or branch shall, together with the annual return, send a copy of the special report of the auditors.

(4) In the case of a branch the annual return shall be sent to the Registrar through an officer appointed in that behalf by the society of which the branch forms part.

Quinquennial valuation

28.—(1) Every registered society and branch shall, except as in this section provided, once at least in every five years either—

(a) cause its assets and liabilities to be valued by a valuer to be appointed by the society or branch and send to the Registrar a report on the condition of the society or branch; or

(b) send to the Registrar a return of the benefits assured and contributions receivable from all the members of the society or branch, and of all its funds and effects, debts and credits, accompanied by such evidence in support thereof as the Chief Registrar prescribes.

(2) If the society or branch sends to the Registrar such report as aforesaid, the report must—

(a) be signed by the valuer; and

(b) state the address and calling or profession of the valuer; and

(c) contain an abstract to be made by the valuer of the results of his valuation, together with a statement containing such information with respect to the benefits assured and the contributions receivable by the society or branch, and of its funds and effects, debts and credits, as the Registrar may require.

(3) If the society or branch sends to the Registrar such return as aforesaid, he

* See Sections 14 and 20 of the Industrial Assurance and Friendly Societies Act, 1948. By Section 20, the designation 'Approved Auditor' is substituted for 'Public Auditor', and this amendment has here been given effect to.—Ed.

shall cause the assets and liabilities of the society or branch to be valued and reported on by some actuary, and shall send to the society or branch a copy of the report and an abstract of the results of the valuation.

(4) Provided that this section shall not apply to—

(a) a benevolent society, working men's club, cattle insurance society or branch thereof; or

(b) a specially authorised society or branch unless it is so directed in the authority for registering that society or branch.

(5) Provided also that the Chief Registrar may, with the approval of the Treasury, dispense with the provisions of this section in respect of societies or branches to whose purposes or to the nature of whose operations he may deem those provisions inapplicable.

Balance sheet

29. Every registered society and branch shall keep a copy of the last annual balance sheet, and of the last quinquennial valuation, together with any special report of the auditors, always hung up in a conspicuous place at the registered office of the society or branch.

Approved auditors and valuers

30.*—(1) For the purpose of audits and valuations to be made under this Act the Treasury may appoint approved auditors and valuers and may determine the rates of remuneration to be paid by societies and branches for the services of those auditors and valuers.

(2) The Treasury may, out of money to be provided by Parliament, pay to the approved auditors and valuers such remuneration (if any) as the Treasury may allow.

Exemptions from Stamp Duty

33. Stamp duty shall not be chargeable upon any of the following documents:

(a) Draft or order or receipt given by or to a registered society or branch in respect of money payable by virtue of its rules or of this Act.

(b) Letter or power of attorney granted by any person as trustee for the transfer of any money of a registered society or branch invested in his name in the public funds.

(c) Bond given to or on account of a registered society or branch or by the treasurer or other officer thereof.

(d) Policy of insurance or appointment or revocation of appointment of agent or other documents required or authorised by this Act or by the rules of a registered society or branch.

Rights of members, &c.

39. Every registered society and branch shall supply gratuitously to every member or person interested in its funds, on his application, either

(a) a copy of the last annual return of the society or branch; or

(b) a balance sheet or other documents duly audited containing the same particulars as to the receipts and expenditure, funds and effects, of the society or branch as are contained in the annual return.

40. A member or person having an interest in the funds of a registered society or branch may inspect the books at all reasonable hours at the registered office of the society or branch, or at any place where the books are kept, except that the member or person shall not, unless he is an officer of the society or branch or is specially authorised by a resolution of the society or branch to do so, have the right to inspect the loan account of any other member, without the written consent of that member.

41.—(1) A member or person claiming through a member of a registered friendly society or branch, shall not be entitled to receive more than two hundred pounds by way of gross sum, together with any bonuses or additions declared upon assurances not exceeding that amount or (except as provided by this Act) fifty pounds a year by way of annuity, from any one or more such societies or branches.

* An amendment made by the Industrial Assurance and Friendly Societies Act, 1948, has here been given effect to.—Ed.

(2) Any such society or branch may require a member or person claiming through a member, to make and sign a statutory declaration that the total amount to which that member or person is entitled from one or more such societies or branches does not exceed the sums aforesaid.

42. The rules of a registered society or branch may provide for accumulating at interest, for the use of any member, any surplus of his contributions to the funds of the society or branch which may remain after providing for any assurance in respect of which they are paid and for the withdrawal of the accumulations.

Property, funds and investments

44.—(1) The trustees of a registered society or branch may, with the consent of the committee or of a majority of the members present and entitled to vote in general meeting, invest the funds of the society or branch or any part thereof, to any amount in any of the following ways:

- (a) In the Post Office Savings Bank or in any savings bank, certified under the Trustee Savings Banks Act, 1863; or
- (b) In the public funds; or
- (d) In the purchase of land or in the erection or alteration of offices or other buildings thereon; or
- (e) Upon any other security expressly directed by the rules of the society or branch, not being personal security, except as in this Act authorised with respect to loans.

(2) The rules of a society with branches and of any branch thereof may provide for the investment of funds of the society or of that branch by the trustees of any branch, or by the trustees of the society, and the consent required for any such investment shall be the consent of the committee, or of such majority as aforesaid of the society or branch by whom the funds are invested.

45.—(1) A registered society and, subject to the rules of the society, a registered branch may advance to a member of at least one full year's standing any sum not exceeding one-half of the amount of an assurance on his life, on the written security of himself and two satisfactory sureties for repayment.

(2) The amount so advanced, with all interest thereon, may be deducted from the sum assured, without prejudice in the meantime to the operation of the security.

46. A registered society may, out of any separate loan fund to be formed by contributions or deposits of its members, make loans to members on their personal security, with or without sureties, as may be provided by the rules, subject to the following restrictions—

- (a) A loan shall not at any time be made out of money contributed for the other purposes of the society;
- (b) A member shall not be capable of holding any interest in the loan fund exceeding two hundred pounds;
- (c) A society shall not make any loan to a member on personal security beyond the amount fixed by the rules, or make any loan which, together with any money owing by a member to the society, exceeds fifty pounds.
- (d) A society shall not hold at any one time on deposit for its members any money beyond the amount fixed by the rules, and the amount so fixed shall not exceed two-thirds of the total sums owing to the society by the members who have borrowed from the loan fund.

47.—(1) A registered society or branch may (if the rules thereof so provide) hold, purchase, or take on lease in the name of the trustees of the society or branch any land, and may sell, exchange, mortgage, lease, or build upon that land (with power to alter and pull down buildings and again rebuild), and a purchaser, assignee, mortgagee, or tenant shall not be bound to inquire as to the authority for any sale, exchange, mortgage or lease by the trustees, and the receipt of the trustees shall be a discharge for all sums of money arising from or in connection with the sale, exchange, mortgage, or lease.

(2) A branch of a registered society need not for the purposes of this section be separately registered.

(3) Nothing in this section shall authorise a benevolent society to hold land exceeding one acre in extent.

48. Where a registered society or branch is entitled in equity to any heredita-

ments or copyhold or customary tenure, either absolutely or by way of mortgage or security, the lord of the manor of which the hereditaments are held shall, if the society or branch so requires, admit not more than three trustees of the society or branch as tenants in respect of such hereditaments, on payment of the usual fines, fees and other dues payable on the admission of a single tenant.

49.—(1) All property belonging to a registered society, whether acquired before or after the society is registered, shall vest in the trustee for the time being of the society, for the use and benefit of the society, and the members thereof, and of all persons claiming through the members according to the rules of the society.

(2) The property of a registered branch of a society shall vest wholly or partly in the trustees for the time being of that branch or of any other branch of which that branch forms part (or, if the rules of the society so provide, in the trustees for the time being of the society), for the use and benefit either of the members of any such branch and persons claiming through those members, or of the members of the society generally, and persons claiming through them, according to the rules of the society.

(3) The trustees shall not be liable to make good any deficiency in the funds of the society or branch, but shall be liable only for sums of money actually received by them respectively on account of the society or branch.

50. Upon the death, resignation, or removal of a trustee of a registered society or branch, the property vested in that trustee shall, without conveyance or assignment, and whether the property is real or personal, vest, as personal estate subject to the same trusts, in the succeeding trustees of that society or branch either solely or together with any surviving or continuing trustees, and until the appointment of succeeding trustees, shall so vest in the surviving or continuing trustees only, or in the executors or administrators of the last surviving or continuing trustee, except that stocks and securities in the public funds of Great Britain and Ireland shall be transferred into the names of the succeeding trustees, either solely or jointly with any surviving or continuing trustees.

51. In all legal proceedings whatsoever concerning any property vested in the trustees of a registered society or branch, the property may be stated to be the property of the trustees, in their proper names as trustees for the society or branch without further description.

53.—(1) A receipt under the hands of the trustees of a registered society or branch, countersigned by the secretary for all sums of money secured to the society or branch by any mortgage or other assurance, being in the form prescribed by this Act, if endorsed upon or annexed to the mortgage or other assurance, shall vacate the mortgage or assurance and vest the property therein comprised in the person entitled to the equity of redemption of that property, without re-conveyance or re-surrender.

(2) If the mortgage or other assurance has been registered under any Act for the registration or record of deeds or titles, or is of copyholds or of lands of customary tenure and entered on any Court rolls, the Registrar under any such Act, or recording officer, or steward of the manor, or keeper of the register, shall, on production of the receipt, verified by oath of any person, enter satisfaction of the mortgage or charge made by the assurance on the register or Court rolls, and shall grant a certificate, either upon the mortgage or assurance, or separately to the like effect.

(3) The certificate shall be received in evidence in all Courts and proceedings without further proof.

(4) The person making the entry shall be entitled for making the said entry and granting the said certificate to a fee of two shillings and sixpence, which in Ireland shall be paid by stamps and applied in accordance with the Public Offices Fees Act, 1879.

(5) This section shall not extend to Scotland or the Island of Jersey.

Officers in receipt or charge of money

54. Every officer of a registered society or branch having receipt or charge of money shall, if the rules of the society or branch so require, before taking upon himself the execution of his office, become bound with one sufficient surety at the least in a bond or give the security of a guarantee society, in such sum as the

society or branch directs, conditioned for his rendering a just and true account of all sums of money received and paid by him on account of the society or branch at such times as its rules appoint, or as the society or branch or the trustees or committee thereof require him to do, and for the payment by him of all sums due from him to the society or branch.

55.—(1) Every officer of a registered society or branch having receipt or charge of money shall, at such times as by the rules of the society or branch he should render account, or upon demand made, or notice in writing given or left at his last or usual place or residence, give in his account as may be required by the society or branch, or by the trustees or committee thereof, to be examined and allowed or disallowed by them, and shall on the like demand or notice, pay over all sums of money and deliver all property in his hands or custody to such person as the society or branch, or the committee or the trustees appoint.

(2) In case of any neglect or refusal to deliver the account, or to pay over the sums of money or to deliver the property in manner aforesaid, the trustees or authorised officers of the society or branch may sue upon the bond or security before mentioned, or may apply to the County Court or to a Court of summary jurisdiction, and the order of either such Court shall be final and conclusive.

Offences, penalties, and legal proceedings

88. If any person wilfully makes, orders, or allows to be made any entry, erasure in, or omission from a balance sheet of a registered society or branch, or a return or document required to be sent, produced, or delivered for the purposes of this Act, with intent to falsify the same, or to evade any of the provisions of this Act, he shall be liable to a fine not exceeding fifty pounds.

Application of Act

101.—(1) This Act shall apply to societies and branches subsisting at the commencement of this Act, which, or the rules of which, have been registered, enrolled, or certified under any Act relating to friendly societies or cattle insurance societies, as if they had been registered under this Act, and the rules of those societies and branches shall, so far as they are not contrary to any express provisions of this Act, continue in force until altered or rescinded.

(2) Where the contingent annual payments to which the members or the nominees of the members of friendly societies or branches, established before the fifteenth day of August, one thousand eight hundred and fifty may become entitled, exceed the limit fixed by this Act, the rules of those societies and branches shall continue to be valid, anything in this Act to the contrary notwithstanding.

102. In the application of this Act to Scotland—

The expression 'land' shall include heritable subjects of whatever description;

The expressions 'Court of summary jurisdiction' and 'County Court' shall mean the Sheriff Court of the County;

The expression 'administration' shall mean confirmation;

The expression 'misdemeanour' shall mean crime and offence.

SCHEDULES

THE FIRST SCHEDULE

Matters to be provided for by the rules of societies registered under this Act

1. The name and place of office of the society.
2. The whole of the objects for which the society is to be established, the purposes for which the funds thereof shall be applicable, the terms of admission of members, the conditions under which any member may become entitled to any benefit assured thereby, and the fines and forfeitures to be imposed on any member, and the consequences of non-payment of any subscription or fine.
3. The mode of holding meetings and right of voting, and the manner of making, altering, or rescinding rules.
4. The appointment and removal of a committee of management (by whatever name), of a treasurer and other officials and of trustees, and in the case of a

society with branches the composition and powers of the central body, and the conditions under which a branch may secede from the society.

5. The investment of the funds, the keeping of the accounts and the audit of the same once a year at least.

6. Annual returns to the Registrar of the receipts, funds, effects, and expenditure, and number of members of the society.

7. The inspection of the books of the society by every person having an interest in the funds of the society.

8. The manner in which disputes shall be settled.

9. In case of dividing societies, a provision for meeting all claims upon the society existing at the time of division before any such division takes place.

And also in the case of friendly and cattle insurance societies.

10. The keeping separate accounts of all moneys received or paid on account of every particular fund or benefit assured for which a separate table of contributions payable shall have been adopted, and the keeping separate account of the expenses of management, and of all contributions on account thereof.

11. (Except as to cattle insurance societies) a valuation once at least in every five years of the assets and liabilities of the society, including the estimated risks and contributions.

12. The voluntary dissolution of the society by consent in a friendly society of not less than five-sixths in value of the members and of every person for the time being entitled to any benefit from the funds of the society, unless his claim be first satisfied or adequately provided for; and in a cattle insurance society by consent of three-fourths in numbers of the members.

13. The right of one-fifth of the total number of members or of one hundred members in the case of a society of one thousand members and not exceeding ten thousand, or of five hundred members in the case of a society of more than ten thousand members, to apply to the Chief Registrar, or, in the case of societies registered and doing business exclusively in Scotland or Ireland, to the Assistant Registrar for Scotland or Ireland, for an investigation of the affairs of the society, or for winding-up the same.

FRIENDLY SOCIETIES ACT, 1908

8 *Edw. 7, Ch. 32*

An Act to amend the Friendly Societies Act, 1896 (1st August, 1908)

Membership of minors under the age of one year

2.—(1) A person of or under one year of age may be admitted as a member of a registered society or branch, and accordingly in Section 36 of the principal Act (which relates to the membership of minors) the words 'but above one year of age' shall be repealed.

(2) Where the rules of a registered friendly society or branch, in force at the commencement of this Act, provide for the admission as members of persons from the minimum age authorised by the principal Act, the rules shall be construed as providing for the admission as members of persons from birth.

Limitation of benefits

3. In Section 31 of the principal Act 'three hundred pounds' shall be substituted for 'two hundred pounds', and 'fifty-two pounds' for 'fifty pounds', as the maximum amount a member or person claiming through a member of a registered friendly society or branch is entitled to receive by way of gross sum and by way of annuity respectively.

Powers to invest funds in trust securities

4. In subsection (1) of Section 44 of the principal Act (which relates to the manner in which the funds of registered societies and branches may be invested) the following paragraph shall be added after paragraph (e):

'or

(f) in any investment in which trustees are for the time being by law authorised to invest trust funds.'

THE INDUSTRIAL ASSURANCE AND FRIENDLY SOCIETIES ACT, 1948

11 & 12 Geo. 6, Ch. 39

14.—(1) Subject to the provisions of subsection (2) of this section a registered society not being a collecting society shall once at least in every year, beginning with the year nineteen hundred and fifty, submit its accounts for audit to one of the approved auditors appointed under Section 30 of the Act of 1896 (as amended by Section 20 of this Act) notwithstanding anything in subsection (1) of Section 26 of that Act (which confers an option to have accounts audited either as aforesaid or by persons appointed in accordance with the rules of the society).

(2) The option conferred by the said subsection (1) shall continue to be exercisable to the following extent and subject to the following provisions, that is to say—

- (a) the said option shall be exercisable as respects the year nineteen hundred and fifty in the case of a society whose members numbered less than five hundred on the thirty-first day of December, nineteen hundred and forty-nine, and whose assets were then of an aggregate value less than five thousand pounds, and it shall be exercisable also (but subject to the provisions of the next succeeding paragraph) as respects each subsequent year in the case of a society which has been entitled to exercise the said option as respects all preceding years and which satisfied the conditions aforesaid as to number of members and value of assets on the thirty-first day of December immediately before the beginning of the subsequent year in question;
- (b) provision may be made at any time or from time to time by regulations for limiting the exercise of the said option as respects any years subsequent to the year nineteen hundred and fifty, and subsequent to that in which the regulations are made, by substituting for the purposes of the preceding paragraph a prescribed number of members and value of assets being less (as to number or value or as to both) than that mentioned in the preceding paragraph or that prescribed by the regulations then last made, as the case may be, and substituting for the reference in the preceding paragraph to the thirty-first day of December, nineteen hundred and forty-nine, a reference to the thirty-first day of December in the year in which the regulations are made, and ultimately for rendering the said option no longer exercisable in the case of any society; and
- (c) the registrar may give a direction, in the case of any particular society which apart from the direction would be entitled to exercise the said option as respects any year, requiring it to submit its accounts in that year for audit to an approved auditor, and if (as he is hereby authorised to do) the registrar gives such a direction after the society has sent to him its annual return for the year in question, being a return stating that the audit therefor has been conducted by persons other than an approved auditor, he may also direct that the society shall, after its accounts have been audited by an approved auditor and within three months from receipt of the direction, send to him a further annual return complying with the requirements of Section 27 of the Act of 1896 (other than that as to time of sending).
- (3) Regulations for the purposes of the preceding subsection shall be made by the Chief Registrar, subject to the approval of the Treasury signified by statutory instrument which shall be subject to annulment in pursuance of resolution of either House of Parliament.

(4) In subsection (1) of Section 30 of the Act of 1896 (which, as amended by Section 20 of this Act, after dealing with the appointment of approved auditors and public valuers, provides that their employment shall not be compulsory) the words 'but the employment of those auditors and valuers shall not be compulsory' are hereby repealed:

Provided that the said repeal shall not be construed as rendering the employment of an approved auditor or public valuer compulsory in any case in which it would not otherwise be compulsory.

19.—(1) The power to invest funds with the National Debt Commissioners

conferred on registered societies by paragraph (c) of subsection (1) of Section 44, and Section 52 of the Act of 1896, shall cease to be exercisable.

(2) The said Commissioners may at any time make payments in or towards repayment of moneys invested with them by such societies, and shall repay all such moneys not later than the twentieth day of November, nineteen hundred and fifty-one, and the provisions of Sections 26 and 27 of the Trustee Savings Banks Act, 1863 (which, as applied by subsection (4) of Section 52 of the Act of 1896, impose certain restrictions on such payments) shall cease to have effect as to such payments.

(3) Where the said Commissioners propose to make a payment under this section to a registered society, they shall, by not less than twenty-eight days' notice in writing, notify the society of their proposal, specifying the amount and date of the payment proposed, and, if necessary, requiring the society to appoint a person to whom payment may be made.

(4) In accordance with the preceding provisions of this section—

(a) there are hereby repealed paragraph (c) of subsection (1) of Section 44 of the Act of 1896, and, in Section 52 of that Act, subsections (1) to (3), subsection (4) so far as it relates to Sections 26 and 27 of the Trustee Savings Banks Act, 1863, and subsections (6) and (9); and

(b) as from such day as may be appointed for the purposes of this provision by order of the Treasury made by statutory instrument, being a day not earlier than the twentieth day of November, nineteen hundred and fifty-one, the enactments specified in Part I of the Sixth Schedule to this Act shall be repealed to the extent specified in the third column of that Part of that Schedule.

(5) It is hereby declared that nothing in Section 44 of the Act of 1896 (which enacts that the trustees of a registered society may invest its funds to any amount in the ways therein mentioned, including investment in the Post Office Savings Bank or in any savings bank certified under the Trustee Savings Banks Act, 1863), or in any of the following sections (which make similar provision as to investment of the funds, money or capital of the bodies therein respectively mentioned), that is to say—

(a) Section 27 of the Savings Bank Act, 1828, and Section 32 of the Trustee Savings Banks Act, 1863;

(b) Section 1 of the Savings Bank (Charitable Societies) Act, 1859;

(c) Section 39 of the Industrial and Provident Societies Act, 1893; and

(d) Section 16 of the Building Societies Act, 1894;

is to be construed as imposing any obligation on any savings bank authority as respects their or his receiving any such funds, money or capital.

In this subsection the expression 'savings bank authority' has the meaning assigned to it by subsection (3) of Section 10 of the Savings Banks Act, 1920.

(6) This section shall extend to Northern Ireland.

20.—(1) The designation of the auditors appointed under Section 30 of the Act of 1896, and of the auditors appointed under Section 72 of the Industrial and Provident Societies Act, 1893, shall be 'approved auditors' instead of 'public auditors', and accordingly a reference to 'an approved auditor' shall be substituted for any reference to 'a public auditor' in—

(a) the Friendly Societies Acts, 1896 to 1929;

(b) the Industrial Assurance Acts, 1923 to 1929;

(c) the Industrial and Provident Societies Acts, 1893 to 1928;

(d) the Superannuation and Other Trust Funds (Interpretation) Regulations, 1928.

(2) No person shall be qualified to be appointed an approved auditor under Section 30 of the Act of 1896 or under Section 72 of the Industrial and Provident Societies Act, 1893, unless he is a member of one or more of the following bodies, that is to say—

The Institute of Chartered Accountants in England and Wales;

The Society of Incorporated Accountants and Auditors;

The Society of Accountants in Edinburgh;

The Institute of Accountants and Actuaries in Glasgow;

The Society of Accountants in Aberdeen;

The Association of Certified and Corporate Accountants;

The Institute of Chartered Accountants in Ireland;

Provided that—

- (a) the preceding provision shall not affect the qualification of a person who is an approved auditor at the passing of this Act, for the purpose either of his existing appointment or of any subsequent appointment under either of those sections;
- (b) notwithstanding that provision, where a person who is not such a member or an approved auditor at the passing of this Act was appointed in accordance with the rules of a registered society for the purposes of the audit of the accounts of the society made in the years nineteen hundred and forty-eight and nineteen hundred and forty-nine and in each subsequent year (if any) as respects which the option conferred by Section 26 of the Act of 1896 to submit accounts for audit to persons so appointed was exercisable by the society, the Treasury may, if they think fit, appoint him under the said Section 30 for the purposes only of audit of the accounts of a society in accordance with whose rules he was appointed as aforesaid; and
- (c) notwithstanding that provision, the Treasury may, if they think fit, appoint under the said Section 30 a person who is not such a member or an approved auditor at the passing of this Act, if they are satisfied that it is necessary for them to do so for giving effect to the purposes of Section 14 of this Act.

ANNUAL RETURN FOR A REGISTERED FRIENDLY SOCIETY
Year ended 31st December, 1948

(1) A copy of the auditor's special report (if any).

Name of society (as registered).....

Registered office.....

Date of establishment of society.....

at the date,, 1949, on which the annual return is signed

[illegible]

BENEFIT MEMBERS (Membership of a separate Juvenile Society should not be included in the Adult Society's Return)	Ordinary Members		Juvenile Members	Widows	Total
	Males	Females			
Number at the beginning of the year ..					
Admitted					
Juvenile members transferred to Adult Section					
Together					
Number whose membership ceased					
Juvenile members transferred to Adult Section					
Number at end of the year ..					

(A) FUND

Income	£	s	d	Expenditure	£	s	d
Contributions				Sickness Pay:			
Levies for Benefits (state nature of Benefit):				Full pay lasting weeks			
.....				First period reduced pay lasting			
.....				..... weeks			
.....				Further periods of reduced pay ..			
.....				Death Benefit ..			
.....				Other Benefits (to be specified):			
.....						
Transferred from Individual or Deposit Accounts, as per Account (B)				Surrender values			
Net Revenue from Investments				Transferred to Individual or			
Other Income (to be specified):				Deposit Accounts, as per Ac-			
.....				count (B)			
.....				Divided among the members			
.....				under Rule No.			
.....				Deducted for Expenses of Man-			
.....				agement (Rule No.)			
.....				Other Expenditure (to be speci-			
.....				fied):			
.....						
Total				Total			
Balance at beginning of year ..				Balance at end of year, as per			
				Balance Sheet (H)			
TOTAL	£			TOTAL	£		

(B) INDIVIDUAL OR DEPOSIT ACCOUNTS

Transferred from Account (A) ..		Withdrawn at Death	
Added to their accounts by Mem-		Withdrawn at age 60, 65 or 70 ..	
bers		Withdrawn for other reasons ..	
Interest added		Benefits paid (to be specified):	
.....		
.....		
.....		
.....		
.....		
.....		Transferred to Account (A) ..	
.....		Other Expenditure (to be speci-	
.....		fied):	
.....		
.....		
Total		Total	
Balance at beginning of year ..		Balance at end of year, as per	
		Balance Sheet (H)	
TOTAL	£	TOTAL	£

(C)FUND

Contributions		Benefits (to be specified):	
Levies for Benefits (state Benefit):		.....
.....		
Net Revenue from Investments		Deducted for Expenses of Management (Rule No.)	
Other Income (to be specified):		Other Expenditure (to be specified):	
.....		
.....		
Total		Total	
Balance at beginning of year ..		Balance at end of year, as per Balance Sheet (H)	
TOTAL	£	TOTAL	£

(D) MANAGEMENT FUND

Contributions for Management		Salaries or other remuneration:	
Deducted from Benefit Contributions		Secretary	
Levies		Treasurer	
Other Income (to be specified):		Auditors	
.....		Collectors	
.....		Other Officers	
.....		Rent and Rates	
.....		Printing, Stationery and Postage	
.....		Valuation Expenses	
.....		Other Expenses of Management (to be specified):	
.....		
Total		Total	
Deficit at end of year, as per Balance Sheet (H)		Deficit at beginning of year ..	
Balance at beginning of year ..		Balance at end of year, as per Balance Sheet (H)	
TOTAL	£	TOTAL	£

(E) RENT AND INTEREST ACCOUNT

Income	£ s d	Expenditure	£ s d
Interest (Gross) from:		Outgoings on Land and Buildings to be specified):	
Mortgages	
Government Securities*	
Municipal Securities		Interest credited to:	
Other Investments .. ..		..... Fund, Account (A)	
Rents from Land and Buildings		Individual or Deposit Accounts, Account (B)	
Total .. ..		..... Fund, Account (C) ..	
Less Income Tax deducted		Transferred to Management Fund Account (D) to meet cost of managing investments (Rule No.)	
Net total		Transferred to Reserve (if any)	
Bank Interest		Other Expenditure (to be specified):	
Income Tax recovered	
Other Income (to be specified):		
.....		
.....		TOTAL	£
TOTAL	£		

* Including interest added to Savings Certificates where brought into account before realisation.

(F) INVESTMENTS ACCOUNT

*Investments realised during year:		*Investments made during year:	
Depreciation of Investments charged against Fund		Interest added to Savings Certifi- cates (where brought into ac- count before realisation) ..	
		Profit on realisation of Invest- ments carried to Fund	
Total		Total	
Value of Investments at end of year, as per Balance Sheet (H)		Value of Investments at beginn- ing of year	
TOTAL	£	TOTAL	£

* Bank deposits and withdrawals should not be included. Each investment should be fully described. If space is insufficient, separate schedules should be attached.

(G) SAVINGS INVESTMENT FUND AT19.....

This statement is not required to be made out to the date of the Society's annual return, but may show the position at any later date that is found convenient for audit purposes.

<i>Liabilities</i>	<i>£ s d</i>	<i>Assets</i>	<i>£ s d</i>
†(a) Amount of <i>credit</i> issue of National Savings Stamps (contra)		(a) Cash and National Savings Stamps on hand (contra)	
(b) Balance held in respect of Ballot Scheme and/or Vari- able Subscription Scheme (contra)		(b) Cash and National Savings Certificates held in blank (contra)	

† The Auditor(s) should verify this item by reference to the covering letter received from the Registrar.

(H) BALANCE SHEET (EXCLUDING SAVINGS INVESTMENT FUND)

<i>Funds, &c.</i>	£ s d	<i>Assets, &c.</i>	£ s d
BENEFIT AND RESERVE FUNDS:		INVESTMENTS:	
Sickness		National Debt Commissioners	
Death		Mortgages on Land and Buildings ..	
Medical Aid ..		Including (in Scotland) bonds on heritable properties,	
Members, Individual or Deposit Accounts		Land and Buildings	
Dividend Account ..		British Government Securities (to be specified):	
Other Benefit and Reserve Funds (to be specified):		
.....		British Municipal Securities (to be specified):	
.....		
.....		Other Securities (to be specified):	
.....		
Total		Total Investments, as per Account (F)	
MANAGEMENT FUND		Balance at Post Office Savings Bank:	
General Reserve for Depreciation ..		Book No. Soc. F.....	
Due to Treasurer ..		Balance at Trustee Savings Bank	
Other Liabilities (to be specified):		Balance at Bank	
.....		Cash in hand of Treasurer	
.....		..... Secretary	
.....		Other Assets (to be specified):	
.....		
TOTAL	£	Total Assets	
		Deficit in Fund	
		TOTAL	

Signature of Treasurer..

Signature of Secretary .

Address.....

Address.....

Signature of Trustee, who hereby certifies to the Investments shown in Balance Sheet..

NOTE TO AUDITORS

The attention of the Auditors is drawn to the wording of the certificate which they are required to sign. A person who signs the certificate without verifying the Return with the accounts and vouchers relating thereto and without taking proper steps to satisfy himself that it is otherwise in accordance with law is guilty of an offence punishable with a fine not exceeding £50. If, therefore, a person who is asked to act as Auditor, does not feel qualified to carry out a proper audit, he should refuse to act.

The Auditors must make a *Special Report* if in any respect the Annual Return is incorrect, unvouched or not in accordance with law. A copy of any such *Report* must be sent to the Registrar with this Return. If no *Special Report* is made, the words in brackets should be struck out of the certificate.

The undersigned, having had access to all the Books and Accounts of the Society, and having examined the foregoing Annual Return, and verified the same with the Accounts and Vouchers relating thereto now sign the same as found to be correct, duly vouched, and in accordance with law [subject to a *Special Report* dated day of]. See note above.

Signature of 1st Auditor*

Signature of 2nd Auditor*

[or of Approved Auditor].....

.....

Address.....

Address.....

Calling or Profession

Calling or Profession.....

Date of completion of Audit, 19....

* Appointed by under the authority of

TRUSTEE SAVINGS BANK

THE TRUSTEE SAVINGS BANKS ACT, 1863 26 & 27 Vict. Ch. 87

No savings bank, subject to proviso hereinafter contained with respect to branch offices, &c., shall have benefit of this Act, unless in rules, &c., it shall be expressly provided as herein specified

6. No savings bank, subject to the proviso hereinafter contained with respect to the branch offices or local receivers of any savings bank, shall have the benefit of this Act unless in the rules and regulations for the management thereof it shall be expressly provided—

(1) That no person or persons being treasurer, trustee, or manager of such savings bank, or having any control in the management thereof, shall derive any benefit from any deposit made in such savings bank, save only and except such salaries and allowances or other necessary expenses as shall according to such rules and regulations be provided for the charges of managing such savings bank, and for remuneration to officers employed in the management thereof, exclusive of the treasurer or treasurers, trustee or trustees, manager or managers, or other persons having direction in the management of such savings bank, who shall not directly or indirectly have any salary, allowance, profit or benefit whatsoever therefrom beyond their actual expenses for the purposes of such savings bank.

(3) That the depositor's pass book shall be compared with the ledger on every transaction of repayment and on its first production at the bank after each twentieth day of November.

(4) That every depositor in a savings bank established under this Act shall once at least in every year cause his deposit book to be produced at the office of the said savings bank for the purpose of being examined.

(5) That no money be received from or paid to depositors except at the office or branch offices where the business of the savings bank is carried on under the authority of the board of managers, and during the usual hours of public business.

(6) That a public accountant or one or more auditors be appointed by the trustees and managers, but not out of their own body, to examine the books of the bank, and to report in writing to the board or committee of management the result of such audit, not less than once in every half-year, also to examine an extracted list of the depositors' balances made up every year to the twentieth day of November, and to certify as to the correct amount of the liabilities and assets of the bank.

(7) That a book containing such extracted list of every depositor's balance, omitting the name, but giving the distinctive number and separate amount of each, and showing the aggregate number and amount of the whole, checked and certified by such public accountant or auditors, be open at any time during the hours of public business for the inspection of every depositor as respects his own account, to examine his own deposit book therewith, and the general results of the same.

(8) That the trustees and managers or committee of management shall hold meetings once at least in every half-year, and shall keep minutes of their proceedings in a separate book provided for that purpose.

Weekly returns to be made by savings banks to the Commissioners

7. The trustees and managers of every savings bank shall transmit weekly returns to the Commissioners for the reduction of the National Debt, in such form and giving such particulars as the said Commissioners may direct, showing the amounts of the week's transactions of such savings bank, and the amount of the cash balances remaining in the hands of the treasurer or any other person on account of such savings bank.

Trustees of savings banks shall invest all money in the Banks of England or Ireland and not in any other security

15. The several sums of money belonging to any savings bank which the trustees of such savings bank respectively are authorised to invest under this Act or under any rules or regulations of any such savings bank shall, except as

hereinafter excepted, be paid into and vested in the Bank of England or the Bank of Ireland, as the case may require, in the names of the Commissioners for the reduction of the National Debt according to the provisions of this Act, enabling such trustees to make investments in the names of the said Commissioners, and no such sum or sums shall be paid or laid out by the trustees of such savings bank in any other manner or upon any other security whatever, except as aforesaid, and except such sums of money as from time to time shall necessarily remain in the hands of the treasurer or treasurers of such savings bank to answer the exigencies thereof: Provided always, that nothing herein contained shall restrain or prevent any depositor, or any trustee or trustees acting on behalf of any depositor or depositors, or any friendly society, or any charitable or provident institution or society, or penny savings bank, from withdrawing from any such savings bank any sum or sums of money which shall have been deposited by such depositor, friendly society, charitable or provident institution or society, or penny savings bank, and investing the same in any other securities: Provided always that the trustees of any savings bank already established, or which shall take the benefit of this Act in manner hereinbefore provided, shall be and they are hereby empowered to pay into the Banks of England or Ireland (as the case may be) any sum or sums of money, not being less than fifty pounds, to the account of the Commissioners for the Reduction of the National Debt, upon the declaration of the trustees of such savings bank, or any two or more of them, that such moneys belong exclusively to the savings bank for which such payment is intended to be made, whether such moneys shall have been deposited therein before the passing of this Act or thereafter shall be deposited therein, and the cashier or cashiers of the Banks of England and Ireland respectively are hereby required to receive all such moneys, and to place the same into the account raised in the names of the said Commissioners in the books of the Banks of England and Ireland respectively, denominated 'the fund for the banks for savings': Provided, nevertheless, that previous to any payment being made into the Banks of England or Ireland as aforesaid, the person or persons applying for that purpose shall in all cases produce to the officer of the said Commissioners at their office in London or Dublin (as the case may be), an order under the hands of two of the trustees of such savings banks on the account of which such payment is to be made.

Trustees of savings banks shall make up annually accounts of their progress, &c., and transmit the same to the Commissioners for Reduction of the National Debt

55. *For the more effectual ascertaining from time to time the actual and progressive state of the several savings banks enrolled under the provisions of this Act, the trustees and managers of every such savings bank shall annually cause a general statement of the funds of such savings bank invested in the Bank of England or the Bank of Ireland in the names of the Commissioners for the Reduction of the National Debt to be prepared up to the twentieth day of November in each year, showing the balance or principal sum due to all the depositors collectively in such savings bank, and a statement of the expenses incurred, and stating in whose hands such balance shall then be remaining; and every such annual statement shall be attested by two managers or two trustees, or by one manager and one trustee of such savings bank, and every such annual statement shall be countersigned by the secretary or actuary of such savings bank, and all such annual statements shall be transmitted to the office of the said Commissioners for the Reduction of the National Debt in London or Dublin (as the case may be) within nine weeks after the twentieth day of November in each year.

If trustees neglect to transmit such accounts or to obey any orders given pursuant to this Act, Commissioners may close their accounts, &c.

56. And in case the trustees of any such savings bank shall neglect or refuse to make out and transmit such accounts as aforesaid, or in case any such trustees shall at any time neglect or refuse to obey any orders or directions given by the said Commissioners or through their officer, pursuant to the directions of this Act, it shall be lawful for the said Commissioners to close the account of the trustees of such savings bank, and to discontinue the keeping of any further account with the trustees of such savings bank, and to direct that no

* See amendment made by Trustee Savings Banks Act, 1918, Section 1 (2) (e).—ED.

further sum shall be received at the Bank of England or at the Bank of Ireland from the trustees of such savings bank to the account of the said Commissioners until such times as such Commissioners shall think fit: Provided always, that it may be lawful for the said Commissioners to reopen such account, and to allow the growing interest of such account during the time of such discontinuance, and to authorise the receipt of money at the Bank of England or Ireland, whenever such Commissioners shall think fit to do so, upon such trustees complying with the directions of such Commissioners or their officer.

A duplicate of such account shall be affixed in the office of the savings bank

59. The trustees and managers of every such savings bank shall cause a duplicate of every such annual statement, accompanied by a list of the trustees and managers of such institution for the time being, attested and countersigned as aforesaid, to be publicly affixed and exhibited in some conspicuous part of the office or place where the deposits of such savings bank are usually received, for the information of all parties making deposits therein; and every such duplicate shall from time to time remain so affixed and exhibited until the ensuing annual statement shall in like manner be affixed and exhibited as aforesaid; and every depositor shall be entitled to receive from the said savings bank a printed copy of such annual statement on payment of one penny.

Savings banks shall compute interest on 20th May and 20th November half-yearly or yearly

62. For the purpose of rendering the accounts of the several savings banks in Great Britain and Ireland uniform and correspondent with the accounts of the Commissioners for the Reduction of the National Debt, the interest payable to the depositors in such savings banks in Great Britain and Ireland shall from and after the 20th day of November, one thousand eight hundred and sixty-three, be computed half-yearly to the twentieth day of May and the twentieth day of November, or yearly to the twentieth day of November in each year, as the case may be, and to no other periods.

TRUSTEES SAVINGS BANKS ACT, 1918

8 Geo. 5, Ch. 4

An Act to amend the Trustee Savings Banks Acts, 1863 to 1904, with respect to special investments and the separate surplus fund. [18th April, 1918]

Be it enacted by the King's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:

Control of National Debt Commissioners over special investments business

1.—(1) Every trustee savings bank which carries on the business of making special investments shall so far as respects that business be subject to the control of the National Debt Commissioners and shall comply with any directions which may from time to time be given by the Commissioners with respect to that business.

If a bank to which any such directions are given neglects or refuses to comply therewith, the Commissioners may themselves take the necessary steps for giving effect thereto, and for that purpose may do all such things and exercise all such powers as may be done and exercised by the trustees, managers, and other officers of the bank.

(2) Without prejudice to the general power of control hereinbefore given to the Commissioners, the following provisions shall have effect with respect to the special investments business of a trustee savings bank:

- (a) No money received for investment shall be invested, and no securities held on account of special investments shall be sold, except with the approval of the Commissioners.
- (b) No change shall be made in the rate of interest allowed to depositors in respect of special investments except with the approval of the Commis-

- (c) The amount to be expended by the bank for expenses of management on account of the special investments business shall not exceed such an amount as may be allowed by the Commissioners.
- (d) No money received for investment shall be invested except so as to become repayable not later than the expiration of one year, or, if the money is invested in Government securities, three years, from the date of the investment, or so as to be repayable on six months' or some shorter notice.
- (e) There shall be transmitted to the Commissioners, together with the statement required to be transmitted to them under Section 55 of the Trustee Savings Banks Act, 1863, a valuation of the securities held by the bank on account of special investments, and for the purpose of the valuation the value of those securities shall be calculated according to the current market price at the date of the valuation, or, in the case of securities for which there is at that date no current market price, shall be taken to be such an amount as the Commissioners shall fix, having regard to the date of repayment of, and to the rate of interest payable in respect of, the securities.

Establishment of guarantee fund to meet deficiencies on special investments accounts

2.—(1) For the purpose of providing for any deficiency which may arise in respect of special investments made by trustee savings banks, there shall be established a guarantee fund under the control of the Commissioners.

(2) The guarantee fund shall consist of—

- (a) The reserves both in respect of general business and of special investments of all trustee savings banks which make special investments; and
- (b) Such part of the separate surplus fund as stands to the credit of closed trustee savings banks;

and for the purpose aforesaid the reserves of every such trustee savings bank shall be at the disposal of the Commissioners, and the bank shall comply with any directions given by the Commissioners with respect to those reserves for the purpose of giving effect to the provisions of this section.

(3) If on any valuation of the assets belonging to any bank on account of special investments it appears that there is a deficiency, that deficiency shall, in the event of the bank being closed or wound up, or discontinuing, with the consent of the Commissioners, the business of making special investments, be a charge on and be made good out of the guarantee fund, as follows:

- (a) Recourse shall be had in the first instance to the amount standing to the credit of the guarantee fund in respect of the reserves of the bank in question, and, so far as that amount is insufficient for the purpose, to the amount standing to the credit of the guarantee fund in respect of the reserves of other banks and to the part of the separate surplus fund standing to the credit of the guarantee fund *pari passu*; and
- (b) As between the reserves of a bank in connection with special investments and the reserves of a bank in connection with its general business, recourse shall be had in the first instance to the reserves in connection with special investments, and as between the banks other than the bank in connection with whose account the deficiency has arisen the amount falling to be charged on the reserves of those banks shall be allocated *pro rata* to those reserves according to their several amounts.

(4) So much of paragraph (e) of Section 10 of the Savings Banks Act, 1891, as enacts that the assets of a bank in respect of ordinary deposits are not to be liable for any loss or deficiency in respect of special investments shall cease to have effect so far as relates to such assets of the bank as are reserves within the meaning of this Act.

THE SAVINGS BANKS ACT, 1891

54 & 55 Vict. Ch. 21

Establishment of inspection committee

2.—(1) There shall be established an inspection committee of trustee savings banks.

Powers and duties of inspection committee

3.—(4) The trustees of every trustee savings bank shall, on the requisition of the committee, supply the committee with a copy of the pass book in use in the bank, of the annual general statement of the accounts of the bank, and of the rules of the bank, and of any amendments thereof.

(5) If in the opinion of the committee the rules of any such bank are insufficient for the purpose of maintaining an efficient audit, the bank shall with all convenient speed make such additional rules as may, in the opinion of the committee, be required for the purpose.

(6) If the bank do not, within the time specified by the committee from the date of being required to make any such rules comply with the requirement, the committee may make such rules, and shall submit the rules so made to the Registrar of Friendly Societies, to be certified by him; and, when so certified, they shall be binding on the trustees.

Form of annual statement by trustees of trustee savings banks

8. The annual statement required by Section 55 of the Trustee Savings Banks Act, 1863, to be made by the trustees and managers of every trustee savings bank, shall be in such form and contain or be accompanied by such particulars as the National Debt Commissioners direct. A similar statement shall be sent to the inspection committee each year at the same time.

SAVINGS BANKS ACT, 1920

10 & 11 Geo. 5, Ch. 12

Provisions as to limits on savings bank deposits and on investment in Government stock

1.—(1) There shall, subject as hereinafter provided, be no limit on the amount which may be received by a savings bank authority from any person by way of deposit or on the amount of Government stock which may be credited by a savings bank authority to the account of any depositor, and all enactments imposing or relating whether directly or indirectly to, any such limit shall cease to have effect.

Provided that it shall be lawful for the Treasury at any time by order under this section to limit the amount which may be so received from any person whatsoever either in any one year or in the aggregate, or the amount of Government stock which may be so credited to any person whatsoever either in one year or in the aggregate.

CO-OPERATIVE ACCOUNTS, &c.

THE INDUSTRIAL AND PROVIDENT SOCIETIES

(AMENDMENT) ACT, 1913

3 & 4 Geo. 5, Ch. 31

Audit of accounts

2.*—(1) Every registered society shall once in every year submit its accounts for audit to one or more of the approved auditors appointed under the provisions of the principal Act.

(2) An auditor shall not hold any other office in connection with the society.

Annual return

3.—(1) For paragraph (c) of subsection (2) of Section 14 of the principal Act (which relates to the date to which annual returns are to be made up) the following paragraph shall be substituted:

* By Section 20 of the Industrial Assurance and Friendly Societies Act, 1948, the designation 'Approved Auditor' is substituted for 'Public Auditor', and this amendment has here been given effect to.—Ed.

'(c) shall be made up from the date of its registration or last annual return to that of its last published balance sheet, unless the last-mentioned date is more than four months before or more than one month after the thirty-first day of December, in which case it shall be made up to the said thirty-first day of December inclusive; and'

(2) A registered society shall, together with the annual return, send to the Registrar a copy of the report of the auditors and a copy of each balance sheet made during the period included in the return.

Triennial returns of shareholders

4. A registered society shall, once at least in every three years, make out and send to the Registrar, together with the annual return for the year, a special return signed by the auditor or auditors showing the holding of each person in the society (whether in shares or loans) at the date to which the said annual return is made out: Provided that, where such persons are in the list of members kept by the society distinguished by numbers, it shall be sufficient if they are distinguished in the special return by such numbers, and in that case it shall not be necessary to specify their names.

SOLICITORS' ACCOUNTS

SOLICITORS ACT, 1933

23 & 24 Geo. 5, Ch. 24

Council of Law Society to make rules as to certain matters

1. The Council of the Law Society shall make rules—

- (a) as to the opening and keeping by solicitors of accounts at banks for clients' moneys; and
 - (b) as to the keeping by solicitors of accounts containing particulars and information as to moneys received, held or paid by them, for or on account of their clients; and
 - (c) empowering the Council to take such action as may be necessary to enable them to ascertain whether or not the rules are being complied with;
- and may if they see fit, make rules for regulating in respect of any other matter the professional practice, conduct, and discipline of solicitors:

Provided that rules made under this section shall not come into operation until they have been approved by the Master of the Rolls.

Consequences of failure to comply with rules

2.—(1) If a solicitor fails to comply with any of the rules made under the preceding section, any person may make a complaint in respect of that failure to the disciplinary committee.

(2) The provisions of Part I of the Solicitors Act, 1932, shall apply in relation to complaints under this section as they apply in relation to applications to the committee under the said Part I:

Provided that in addition to the powers conferred on the committee by subsection (2) of Section 5 of the said Act the committee and, upon appeal, the High Court shall have power to impose on the solicitor a penalty not exceeding five hundred pounds, and any penalty so imposed shall be forfeit to his Majesty.

Discretion of Registrar to refuse practising certificate in certain cases

3. Section 38 of the Solicitors Act, 1932 (which gives a discretion to the Registrar of Solicitors to refuse to issue certificates in special cases), shall, in addition to the cases mentioned therein, apply to the case where a solicitor applies for a certificate to practise without having paid any penalty imposed upon him under the last preceding section, or any costs ordered to be paid by him under that section or under Part I of the Solicitors Act, 1932.

Relief to banks

8.—(1) Subject to the provisions of this section no bank shall, in connection with any transaction on any account of any solicitor kept with it or with any other bank (other than an account kept by a solicitor as trustee for a specified beneficiary) incur any liability or be under any obligation to make any enquiry or be deemed to have any knowledge of any right of any person to any money paid or credited to any such account which it would not incur or be under or be deemed to have in the case of an account kept by a person entitled absolutely to all the money paid or credited to it:

Provided that nothing in this subsection shall relieve a bank from any liability or obligation under which it would be apart from this Act.

(2) Notwithstanding anything in the preceding subsection, a bank at which a solicitor keeps an account for clients' moneys shall not, in respect of any liability of the solicitor to the bank, not being a liability in connection with that account, have or obtain any recourse or right whether by way of set off, counter-claim, charge or otherwise, against moneys standing to the credit of that account:

Provided that nothing in this subsection shall deprive a bank of any right existing at the time when the first rules made under this Act come into operation.

SOLICITORS' ACCOUNTS RULES, 1945

Rules dated June 9, 1944, made by the Council of The Law Society and approved by the Master of the Rolls under Section I of the Solicitors Act, 1933 (23 & 24 Geo. 5, C. 24)

1. These Rules may be cited as the Solicitors' Accounts Rules, 1945, and shall come into operation on the 1st day of January, 1945, whereupon the Solicitors' Accounts Rules, 1935, as amended on the 2nd day of March, 1939, the 21st day of June, 1940, and the 14th day of May, 1941, shall cease to have effect.

2.—(1) In these Rules, unless the context otherwise requires—

'Solicitor' shall mean a solicitor of the Supreme Court and shall include a firm of solicitors;

'Client' shall mean any person on whose account a solicitor holds or receives client's money;

'Client's money' shall mean money held or received by a solicitor on account of a person for whom he is acting in relation to the holding or receipt of such money either as a solicitor or, in connection with his practice as a solicitor, as agent, bailee, stakeholder or in any other capacity: Provided that the expression 'client's money' shall not include—

(a) money held or received on account of the trustees of a trust of which the solicitor is solicitor-trustee; or

(b) money to which the only person entitled is the solicitor himself or, in the case of a firm of solicitors, one or more of the partners in the firm;

'Trust money' shall mean money held or received by a solicitor which is not client's money and which is subject to a trust of which the solicitor is a trustee whether or not he is solicitor-trustee of such trust;

'Client account' shall mean a current or deposit account at a bank in the name of the solicitor in the title of which the word 'client' appears; and

'Solicitor-trustee' shall mean a solicitor who is a sole trustee or who is co-trustee only with a partner, clerk or servant of his or with more than one of such persons.

(2) Other expressions in these Rules shall have the meanings assigned to them by the Solicitors Acts, 1932 to 1941.

(3) The Interpretation Act, 1889, shall apply to these Rules in the same manner as it applies to an Act of Parliament, and for the purposes of Section 38 of the said Act the Solicitors' Accounts Rules, 1935, as amended as aforesaid shall be deemed to be an enactment repealed by these Rules.

3. Subject to the provisions of Rule 9 hereof, every solicitor who holds or receives client's money, or money which under Rule 4 hereof he is permitted and elects to pay into a client account, shall without delay pay such money

into a client account. Any solicitor may keep one client account or as many such accounts as he thinks fit.

4. There may be paid into a client account—
 - (a) trust money;
 - (b) such money belonging to the solicitor as may be necessary for the purpose of opening or maintaining the account;
 - (c) money to replace any sum which may by mistake or accident have been drawn from the account in contravention of sub-rule (2) of Rule 8 of these Rules; and
 - (d) a cheque or draft received by the solicitor, which under Rule 5 of these Rules he is entitled to split but which he does not split.
5. Where a solicitor holds or receives a cheque or draft which includes client's money or trust money of one or more trusts—
 - (a) he may where practicable split such cheque or draft and, if he does so, he shall deal with each part thereof as if he had received a separate cheque or draft in respect of that part; or
 - (b) if he does not split the cheque or draft, he shall, if any part thereof consists of client's money, and may in any other case, pay the cheque or draft into a client account.
6. No money other than money which under the foregoing Rules a solicitor is required or permitted to pay into a client account shall be paid into a client account.

7. There may be drawn from a client account—

- (a) In the case of client's money—
 - (i) money properly required for a payment to or on behalf of the client;
 - (ii) money properly required for or towards payment of a debt due to the solicitor from the client or in reimbursement of money expended by the solicitor on behalf of the client;
 - (iii) money drawn on the client's authority; and
 - (iv) money properly required for or towards payment of the solicitor's costs where a bill of costs or other written intimation of the amount of the costs incurred has been delivered to the client and the client has been notified that money held for him will be applied towards or in satisfaction of such costs;
- (b) in the case of trust money—
 - (i) money properly required for a payment in the execution of the particular trust; and
 - (ii) money to be transferred to a separate bank account kept solely for the money of the particular trust;
- (c) such money, not being money to which either paragraph (a) or paragraph (b) of this Rule applies, as may have been paid into the account under paragraph (b) or paragraph (d) of Rule 4 of these Rules; and
- (d) money which may by mistake or accident have been paid into the account in contravention of Rule 6 of these Rules:

Provided that in any case under paragraph (a) or paragraph (b) of this Rule the money so drawn shall not exceed the total of the money held for the time being in such account on account of such client or trust.

8.—(1) No money drawn from a client account under sub-paragraph (ii) or sub-paragraph (iv) of paragraph (a), or under paragraph (c) or paragraph (d) of Rule 7 of these Rules shall be drawn except by

- (a) a cheque drawn in favour of the solicitor, or
- (b) a transfer to a bank account in the name of the solicitor not being a client account.

(2) No money other than money permitted by Rule 7 to be drawn from a client account shall be so drawn unless the Council upon an application made to them by the solicitor specifically authorise in writing its withdrawal.

9.—(1) Notwithstanding the provisions of these Rules, a solicitor shall not be under obligation to pay into a client account client's money held or received by him—

- (a) which is received by him in the form of cash, and is without delay paid in cash in the ordinary course of business to the client or a third party; or
- (b) which is received by him in the form of a cheque or draft which is endorsed

over in the ordinary course of business to the client or a third party and is not passed by the solicitor through a bank account; or

- (c) which he pays into a separate banking account opened or to be opened in the name of the client or of some person named by the client.

(2) Notwithstanding the provisions of these Rules, a solicitor shall not pay into a client account client's money held or received by him—

- (a) which the client for his own convenience requests the solicitor to withhold from such account; or
 (b) which is received by him for or towards payment of a debt due to the solicitor from the client or in reimbursement of money expended by the solicitor on behalf of the client; or
 (c) which is paid to him expressly on account of costs incurred, in respect of which a bill of costs or other written intimation of the amount of the costs has been delivered, or as an agreed fee, or on account of an agreed fee, for business undertaken or to be undertaken.

(3) Where a cheque or draft includes other client's money as well as client's money of the nature described in sub-rule (2) of this Rule such cheque or draft shall be dealt with in accordance with Rule 5 of these Rules.

(4) Notwithstanding the provisions of these Rules the Council may upon an application made to them by a solicitor specifically authorise him in writing to withhold any client's money from a client account.

10.—(1) Every solicitor shall at all times keep properly written up such books and accounts as may be necessary,

- (a) to show all his dealings with—

- (i) client's money held or received or paid by him; and
 (ii) any other money dealt with by him through a client account; and
 (b) to distinguish such money held, received or paid by him on account of each separate client and to distinguish such money from other money held, received or paid by him on any other account.

(2) Every solicitor shall preserve for at least six years from the date of the last entry therein all books and accounts kept by him under sub-rule (1) of this Rule.

11.—(1) In order to ascertain whether these Rules have been complied with, the Council, acting either

- (a) on their own motion; or
 (b) on a written statement or request transmitted to them by or on behalf of the governing body of a provincial law society or a committee thereof; or
 (c) on a written complaint lodged with them by a third party;

may require any solicitor to produce at a time and place to be fixed by the Council, his books of account, bank pass books, loose leaf bank statements, statements of account, vouchers and any other necessary documents for the inspection of any person appointed by the Council, and such person shall be directed to prepare for the information of the Council a report on the result of such inspection. Such report may be used as a basis for proceedings under the Solicitors Acts, 1932 to 1941.

(2) Upon being required so to do a solicitor shall produce such books of account, bank pass books, loose-leaf bank statements, statements of accounts, vouchers and documents at the time and place fixed.

(3) In any case in which the governing body of a provincial law society or a committee thereof are of opinion that an inspection should be made under this Rule of the books of account, bank pass books, loose leaf bank statements, statements of account, vouchers and any other necessary documents of a solicitor, it shall be the duty of such governing body or committee to transmit to the council a statement containing all relevant information in their possession and a request that such an inspection be made.

(4) Before instituting an inspection on a written complaint lodged with them by a third party, the council shall require prima facie evidence that a ground of complaint exists, and may require the payment by such party to the council of a reasonable sum to be fixed by them to cover the costs of the inspection, and the costs of the solicitor against whom the complaint is made. The council may deal with any sum so paid in such manner as they think fit.

(5) In this Rule the expression 'provincial law society' shall mean a society

which is for the time being recognised by the council as representative of solicitors practising in some part of England or Wales and shall include the City of London Solicitors Company.

12. A written intimation of the amount of a solicitor's costs incurred and a notification to a client that money held for him will be applied as mentioned in sub-paragraph (iv) of paragraph (a) of Rule 7 of these Rules may be delivered to a client in the same manner as a bill of costs is required to be delivered under subsection (2) of Section 65 of the Solicitors Act, 1932.

13. Every requirement to be made by the council of a solicitor under these Rules shall be made in writing under the hand of the secretary and sent by registered post to the last address of the solicitor appearing in the roll or in the register kept by the Registrar under subsection (2) of Section 37 of the Solicitors Act, 1932, as amended and re-enacted by Section 7 of the Solicitors Act, 1941, and when so made and sent shall be deemed to have been received by the solicitor within forty-eight hours of the time of posting.

14. Nothing in these Rules shall deprive a solicitor of any recourse or right, whether by way of lien, set-off, counter-claim, charge or otherwise, against moneys standing to the credit of a client account.

THE SOLICITORS ACT, 1941

4 & 5 Geo. 6, Ch. 46

1.—(1) Subject to the provisions of subsection (2) of this section, every solicitor shall once in each practice year deliver to the Registrar a certificate signed by an accountant and complying with the provisions of this section (which certificate is in this section referred to as 'an accountant's certificate').

(2) Subsection (1) of this section shall not apply to a solicitor who satisfies the council that owing to the circumstances of his case the delivery of an accountant's certificate is unnecessary.

(3) The council shall make rules (in this section referred to as 'the Accountant's Certificate Rules') to give effect to the provisions of this section and by those rules shall prescribe—

- (a) what qualification shall be held by an accountant by whom an accountant's certificate may be given;
 - (b) the nature and extent of the examination to be made by an accountant of the books and accounts of a solicitor or his firm and of any other relevant documents with a view to the signing of a certificate to be delivered by such solicitor under this section;
 - (c) the form of the accountant's certificate which shall state—
 - (i) that in compliance with this section and the rules made thereunder the accountant has examined the books, accounts and documents of the solicitor or his firm for the accounting period specified in the certificate; and
 - (ii) whether or not from his examination of the books, accounts and documents produced to him and from the information and explanations given to him the accountant is satisfied, and, if he is not satisfied, the matters in respect of which he is not satisfied, that during the accounting period the solicitor or his firm has complied with the provisions of the Solicitors' Accounts Rules; and
 - (d) the evidence, if any, which shall satisfy the council that the delivery of an accountant's certificate is unnecessary and the cases in which such evidence is or is not required.
- (4) The Accountant's Certificate Rules may—
- (a) permit that in special circumstances defined in the rules the accounting period may differ from the period specified in subsection (5) of this section; and
 - (b) regulate any matters of procedure or matters incidental, ancillary or supplemental to the provisions of this section.
- (5) Except in any case where a different period is permissible under the

Accountant's Certificate Rules (in which case the period so permissible may be adopted), the accounting period specified in an accountant's certificate shall—

- (a) begin at the expiry of the last preceding accounting period for which an accountant's certificate shall have been delivered;
 - (b) cover not less than twelve months;
 - (c) terminate not more than twelve months, or such less period as the Accountant's Certificate Rules may prescribe, before the date of the delivery of the certificate to the Registrar; and
 - (d) where possible, consistently with paragraphs (a), (b) and (c) of this subsection, correspond to a period or consecutive periods for which the accounts of the solicitor or his firm are ordinarily made up.
- (6) If any solicitor fails to comply with the provisions of this section or the Accountant's Certificate Rules, a complaint in respect of such failure may be made by or on behalf of the society to the disciplinary committee. The disciplinary enactments shall apply in relation to complaints under this subsection as they apply in relation to applications to the disciplinary committee under those enactments.

(7) A certificate under the hand of the secretary shall, until the contrary is proved, be evidence that a solicitor has or has not, as the case may be, delivered to the Registrar an accountant's certificate or supplied any evidence required under this section or the Accountant's Certificate Rules.

(8) Where a solicitor is employed as a public officer (as defined in subsection (2) of Section 4 of the Solicitors Act, 1933)—

- (a) nothing in this section shall apply to him unless he takes out a practising certificate;
- (b) an accountant's certificate shall in no case deal with books, accounts or documents kept by him in the course of his employment as such public officer, nor shall any examination be made of those books, accounts and documents under the Accountant's Certificate Rules.

18.—(1) The council shall make rules—

- (a) as to the opening and keeping by every solicitor who is a sole trustee or who is co-trustee only with a partner, clerk or servant of his or with more than one of such persons of an account at a bank for moneys of any trust of which he is such a sole trustee or co-trustee;
 - (b) as to the keeping by every solicitor who is a sole trustee or who is co-trustee only with a partner, clerk or servant of his or with more than one of such persons of accounts containing particulars and information as to moneys received, held or paid by him for or on account of any trust of which he is such a sole trustee or co-trustee; and
 - (c) empowering the council to take such action as may be necessary to enable them to ascertain whether or not the rules are being complied with.
- (2) If a solicitor fails to comply with any of the rules made under this section, any person may make a complaint in respect of that failure to the disciplinary committee. The disciplinary enactments shall apply in relation to complaints under this subsection as they apply in relation to applications to the disciplinary committee under those enactments.

(3) Rules made under paragraph (a) or paragraph (b) of subsection (1) of this section shall not apply to—

- (a) a solicitor acting in the course of his employment as a public officer as defined by Section 4 of the Solicitors Act, 1933; or
- (b) a solicitor acting in the course of his employment in an office to which Section 5 of that Act applies; or
- (c) a solicitor in whole-time employment as an officer of a local authority as defined by Section 6 of that Act acting as such officer.

SOLICITORS' TRUST ACCOUNTS RULES, 1945

RULES DATED 9TH JUNE, 1944, MADE BY THE COUNCIL OF THE LAW SOCIETY UNDER SECTION 18 OF THE SOLICITORS ACT, 1941

1. These Rules may be cited as the Solicitors' Trust Accounts Rules, 1945, and shall come into operation on the 1st day of January, 1945.

2.—(1) In these Rules, unless the context otherwise requires—

'Client account' shall mean a current or deposit account at a bank in the title of which the word 'client' appears, kept and operated in accordance with the provisions of the Solicitors' Accounts Rules;

'Solicitor-trustee' shall mean a solicitor who is a sole trustee or who is co-trustee only with a partner, clerk or servant of his or with more than one of such persons;

'Trust bank account' shall mean a current or deposit account in the title of which the word 'trustee' or 'executor' appears kept at a bank in the names of the trustees of the trust and kept solely for money subject to a particular trust of which the solicitor is solicitor-trustee.

(2) Other expressions in these Rules shall have the meanings assigned to them by the Solicitors Acts, 1932 to 1941.

(3) The Interpretation Act, 1889, shall apply to these Rules in the same manner as it applies to an Act of Parliament.

3. Subject to the provisions of Rule 9 of these Rules every solicitor-trustee who holds or receives money subject to a trust of which he is solicitor-trustee, other than money which is paid into a client account as permitted by the Solicitors' Accounts Rules, shall without delay pay such money into the trust bank account of the particular trust.

4. There may be paid into a trust bank account—

- (a) money subject to the particular trust;
- (b) such money belonging to the solicitor-trustee or to a co-trustee as may be necessary for the purpose of opening or maintaining the account; or
- (c) money to replace any sum which may by mistake or accident have been drawn from the account in contravention of Rule 8 of these Rules.

5. Where a solicitor holds or receives a cheque or draft which includes money subject to a trust or trusts of which the solicitor is solicitor-trustee—

- (a) he shall where practicable split such cheque or draft and, if he does so, shall deal with each part thereof as if he had received a separate cheque or draft in respect of that part; or
- (b) if he does not split the cheque or draft, he may pay it into a client account as permitted by the Solicitors' Accounts Rules.

6. No money, other than money which under the foregoing Rules a solicitor is required or permitted to pay into a trust bank account, shall be paid into a trust bank account.

7. There may be drawn from a trust bank account—

- (a) money properly required for a payment in the execution of the particular trust;
- (b) money to be transferred to a client account;
- (c) such money, not being money subject to the particular trust, as may have been paid into the account under paragraph (b) of Rule 4 of these Rules; or
- (d) money which may by mistake or accident have been paid into the account in contravention of Rule 6 of these Rules.

8. No money other than money permitted by Rule 7 of these Rules to be drawn from a trust bank account shall be so drawn unless the council upon an application made to them by the solicitor expressly authorise in writing its withdrawal.

9. Notwithstanding the provisions of these Rules a solicitor shall not be under obligation to pay into a trust bank account money held or received by him which is subject to a trust of which he is solicitor-trustee and which is received by him either in the form of cash which is without delay paid in cash in the execution of the trust to a third party or in the form of a cheque or draft which is without delay endorsed over in the execution of the trust to a third party and is not passed by the solicitor through a bank account.

10.—(1) Every solicitor-trustee shall at all times keep properly written-up such books and accounts as may be necessary—

- (a) to show separately all his dealings with money held received or paid by him on account of each trust of which he is solicitor-trustee; and
- (b) to distinguish the same from money held received or paid by him on any other account.

(2) Every solicitor-trustee shall preserve for at least six years from the date of the last entry therein all books and accounts kept by him under sub-rule (1) of this Rule.

11.—(1) In order to ascertain whether these Rules have been complied with, the council, acting either—

(a) on their own motion; or

(b) on a written statement or request transmitted to them by or on behalf of the governing body of a provincial law society or a committee thereof; or

(c) on a written complaint lodged with them by a third party.

may require any solicitor-trustee to produce at a time and place to be fixed by the council, all books of account, bank pass books, loose-leaf bank statements, statements of account, vouchers and documents relating to all or any of the trusts of which he is solicitor-trustee for the inspection of any person appointed by the council, and such person shall be directed to prepare for the information of the council a report on the result of such inspection. Such report may be used as a basis for proceedings under the Solicitors Acts, 1932 to 1941.

(2) Upon being required so to do a solicitor-trustee shall produce such books of account, bank pass books, loose-leaf bank statements, statements of account, vouchers and documents at the time and place fixed.

(3) In any case in which the governing body of a provincial law society or a committee thereof are of opinion that an inspection should be made under this Rule of books of account, bank pass books, loose-leaf bank statements, statements of account, vouchers and documents relating to all or any of the trusts of which a solicitor is solicitor-trustee it shall be the duty of such governing body or committee to transmit to the council a statement containing all relevant information in their possession and a request that such an inspection be made.

(4) Before instituting an inspection on a written complaint lodged with them by a third party, the council shall require *prima facie* evidence that a ground of complaint exists, and may require the payment by such party to the council of a reasonable sum to be fixed by them to cover the costs of the inspection, and the costs of the solicitor-trustee against whom the complaint is made. The council may deal with any sum so paid in such manner as they think fit.

(5) For the purpose of the Rule the expression 'provincial law society' means a society which is for the time being recognised by the council as representative of solicitors practising in some part of England or Wales and shall include the City of London Solicitors Company.

12. Every requirement to be made by the council of a solicitor-trustee under these Rules shall be made in writing under the hand of the secretary and sent by registered post to the last address of the solicitor-trustee appearing in the Roll or in the register kept by the Registrar under subsection (2) of Section 37 of the Solicitors Act, 1932, as amended and re-enacted by Section 7 of the Solicitors Act, 1941, and, when so made and sent, shall be deemed to have been received by the solicitor-trustee within forty-eight hours of the time of posting.

13. Nothing in these Rules shall deprive a solicitor of any recourse or right whether by way of lien, set-off, counter-claim, charge or otherwise, against moneys standing to the credit of a trust bank account.

THE PREVENTION OF FRAUD (INVESTMENTS) ACT, 1939 2 & 3 Geo. 6, Ch. 16

1.—(1) Subject to the provisions of the next following section, no person shall, on or after the appointed day—

(a) carry on or purport to carry on the business of dealing in securities except under the authority of a principal's licence, that is to say, a licence under this Act authorising him to carry on the business of dealing in securities; or

(b) in the capacity of a servant or agent of any person carrying on or purporting to carry on that business, deal or purport to deal in securities except under the authority of a representative's licence, that is to say, a licence under this Act authorising him to deal in securities as a servant or agent of any holder of a principal's licence for the time being in force.

(2) Any person who contravenes this section shall be liable, on conviction on indictment, to imprisonment for a term not exceeding two years or to a fine not exceeding five hundred pounds or to both such imprisonment and such fine or, on summary conviction, to imprisonment for a term not exceeding six months or to a fine not exceeding one hundred pounds or to both such imprisonment and such fine.

(3) Proceedings for an offence under this section shall not, in England, be instituted except by, or with the consent of, the Board of Trade or the Director of Public Prosecutions:

Provided that this subsection shall not prevent the arrest, or the issue or execution of a warrant for the arrest, of any person in respect of such an offence, or the remanding, in custody or on bail, of any person charged with such an offence, notwithstanding that the necessary consent to the institution of proceedings for the offence has not been obtained.

2.—(1) The restrictions imposed by Section 1 of this Act in relation to dealing in securities shall not apply to the doing of anything by, or on behalf of

- (a) a member of any recognised stock exchange or recognised association of dealers in securities; or
- (b) the Bank of England, any statutory corporation or municipal corporation, any exempted dealer or any industrial and provident society or building society; or
- (c) any person acting in the capacity of manager or trustee under an authorised unit trust scheme.

(2) For the purpose of determining whether or not a person has contravened any of the restrictions imposed by Section 1 of this Act, no account shall be taken of his having done any of the following things (whether as a principal or as an agent), that is to say—

- (a) effecting transactions with, or through the agency of—
 - (i) such a person as is mentioned in paragraph (a), paragraph (b) or paragraph (c) of the preceding subsection, or a person acting on behalf of such a person as is so mentioned; or
 - (ii) the holder of a licence;
- (b) issuing any prospectus to which—
 - (i) Section 38 of the Companies Act, 1948, applies or would apply if not excluded by paragraph (b) of subsection (5) of that section or by Section 39 of that Act; or
 - (ii) Section 417 of that Act applies or would apply if not excluded by paragraph (b) of subsection (5) of that section or by Section 418 of that Act;
- (c) issuing any document relating to securities of a corporation incorporated in Great Britain which is not a registered company, being a document which
 - (i) would, if the corporation were a registered company, be a prospectus to which Section 38 of the Companies Act, 1948, applies or would apply if not excluded by paragraph (b) of subsection (5) of that section or by Section 39 of that Act; and
 - (ii) contains all the matters and is issued with the consents which, by virtue of Sections 417 and 419 of that Act it would have to contain and be issued with if the corporation were a company incorporated outside Great Britain and the document were a prospectus issued by that company; and
- (d) issuing any form of application for shares in, or debentures of, a corporation together with—
 - (i) a prospectus which complies with the requirements of Section 38 of the Companies Act, 1948, or is not required to comply therewith because excluded by paragraph (b) of subsection (5) of that section or by Section 39 of that Act, or complies with the requirements of Part X of that Act relating to prospectuses and is not issued in contravention of Section 419 of that Act; or
 - (ii) in the case of a corporation incorporated in Great Britain which is not a registered company, a document containing all the matters and

issued with the consents mentioned in sub-paragraph (ii) of paragraph (c) of this subsection;

or of his having, as a principal, acquired, subscribed for or underwritten securities, or effected transactions with a person whose business involves the acquisition and disposal, or the holding, of securities (whether as a principal or as an agent).

Nothing in this subsection shall be construed as authorising any person to hold himself out as carrying on the business of dealing in securities.

12.—(1) Any person who, by any statement, promise or forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts, or by the reckless making of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person—

(a) to enter into or offer to enter into—

- (i) any agreement for, or with a view to, acquiring, disposing of, subscribing for or underwriting securities or lending or depositing money to or with any industrial and provident society or building society, or
- (ii) any agreement the purpose or pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities, or

(b) to acquire or offer to acquire any right or interest under any arrangements the purpose or effect, or pretended purpose or effect, of which is to provide facilities for the participation by persons in profits or income alleged to arise or to be likely to arise from the acquisition, holding, management or disposal of any property other than securities, or

(c) to enter into or offer to enter into an agreement the purpose or pretended purpose of which is to secure a profit to any of the parties by reference to fluctuations in the value of any property other than securities,

shall be guilty of an offence, and liable to penal servitude for a term not exceeding seven years.

(2) Any person guilty of conspiracy to commit an offence under the preceding subsection shall be punishable as if he had committed such an offence.

16.—(1) The Board of Trade may by order declare to be an authorised unit trust scheme for the purposes of this Act any unit trust scheme in relation to which the Board are satisfied that the following conditions are fulfilled, that is to say:

(a) that each of the persons who are respectively the manager and the trustee under the scheme is a corporation incorporated under the law of some part of the United Kingdom, and having a place of business in Great Britain at which notices and other documents are received on behalf of the corporation; and

(b) that the scheme is such that the effective control over the affairs of the corporation which is the manager under the scheme is and will be exercised independently of the corporation which is the trustee under the scheme; and

(c) that the scheme is such as to secure that any trust created in pursuance of the scheme is expressed in a deed providing, to the satisfaction of the Board, for the matters specified in the Schedule to this Act; and

(d) as respects the corporation being the trustee, either—

(i) that the corporation has a capital (in stock or shares) for the time being issued of not less than five hundred thousand pounds, of which an amount of not less than two hundred and fifty thousand pounds has been paid up, and that the assets of the corporation are sufficient to meet its liabilities (including liabilities in respect of the repayment of its capital); or

(ii) that more than four-fifths of the said capital of the corporation is held by another corporation being a corporation in relation to which the conditions as to capital and assets specified in sub-paragraph (i) of this paragraph are fulfilled:

Provided that, if with respect to any trust the Board of Trade are satisfied that, by reason of the special circumstances of the trust, the fulfilment in relation thereto of the condition specified in paragraph (c) of this subsection is impracticable, the Board may dispense with the fulfilment of that condition in relation to that

trust so far as it appears to them that they can properly do so without prejudicing the interests of the beneficiaries.

(2) If, with respect to any authorised unit trust scheme, the Board of Trade consider that the order declaring the scheme to be an authorised unit trust scheme ought to be revoked on either of the following grounds, that is to say—

(a) that the conditions specified in paragraphs (a) to (d) of the preceding subsection are no longer fulfilled in the case of that scheme; or

(b) that the circumstances relevant to the making of an order have materially changed since the making thereof;

the Board may serve on the manager under the scheme and on the trustee under the scheme a written notice that they are considering the revocation of the order on that ground, specifying the respect in which the said conditions are no longer fulfilled or the said circumstances have changed, as the case may be, and inviting the manager and the trustee to make to the Board, within the period of one month from the date of the service of the notice, any representations which they desire to make with respect to the proposed revocation of the order; and the Board may revoke the order after the expiration of the said period, but, before deciding whether or not to revoke the order, shall take into consideration any representations so made by the manager or trustee and, if he so requests, afford him an opportunity of being heard by the Board within that period.

(3) The terms of any trust created before the commencement of this Act in pursuance of a unit trust scheme may, notwithstanding anything in any deed, be varied or supplemented by a deed made between the trustee and the manager under the scheme, and containing such provisions as may be certified by the Board of Trade to be necessary for the purpose of securing that the condition mentioned in paragraph (c) of subsection (1) of this section is fulfilled in relation to that scheme.

(4) The Board of Trade shall, not less often than once a year, cause particulars of every unit trust scheme which is for the time being an authorised unit trust scheme, to be published in such manner as they think proper.

SCHEDULE

MATTERS FOR WHICH TRUST DEEDS PURSUANT TO UNIT TRUST SCHEMES MUST PROVIDE

[*Note*.—Amendments made by the Companies Act, 1947, have here been given effect to.—Ed.]

1. For determining the manner in which the manager's prices for units on a sale and a purchase respectively and the yield therefrom are to be respectively calculated and for entitling the holder of any units to require the manager to purchase them at a price calculated accordingly.

2. For regulating the mode of execution and the issue of unit certificates, and, in particular, for securing that no unit certificate shall be executed or issued in respect of rights or interests in any property until steps have been taken, to the satisfaction of the trustee, to secure that the property will be vested in him, or, subject to any prescribed conditions, in a nominee for him approved by the Board of Trade.

2A. For prohibiting or restricting the issue by or on behalf of the manager of advertisements, circulars or other documents containing any statement with respect to the sale price of units, or the payments or other benefits received or likely to be received by holders of units, or containing any invitation to buy units, unless the document in question also contains a statement of the yield from the units.

3. For securing that any advertisement, circular or other document containing any statement with respect to the sale price of units or the yield therefrom, or containing any invitation to buy units, shall not be issued by or on behalf of the manager until the trustee has had a reasonable opportunity of considering the terms of the document, and shall not be so issued if, within a reasonable time after the document first comes under his consideration, he notifies his disapproval of the terms thereof in writing to the manager.

4. For the establishment of a fund to be applied in defraying the expenses of the administration of the trust and for regulating the application of that fund.

5. For the audit, and the circulation to holders of units, of accounts relating to the trust (including accounts of the manager in relation to the trust and statements of his remuneration in connection therewith).

6. For requiring the manager (subject to any provisions as to appeal contained in the deed) to retire from the trust if the trustee certifies that it is in the interest of the beneficiaries under the trust that he should do so.

In this Schedule the expression 'units' means securities (described whether as units or otherwise) which may be created in pursuance of the unit trust scheme and the expression 'unit certificates' means certificates of the acquisition of such securities.

THE COMPANIES ACT, 1947 10 & 11 Geo. 6, Ch. 47

117.*—(2) The terms of any trust created before the coming into force of this section in pursuance of a unit trust scheme may, notwithstanding anything in any deed, be varied or supplemented by a deed made between the trustee and the manager under the scheme, and containing such provisions as may be certified by the Board of Trade to be consequential on the passing of the foregoing subsection.

(3) The Board of Trade may appoint one or more competent inspectors to investigate and report on the administration of any unit trust scheme within the meaning of the said Act, if it appears to the Board—

(a) that it is in the interests of unit holders so to do; and

(b) that the matter is one of public concern;

and Section 167 of the Companies Act, 1948, subsection (1) of Section 168 thereof and so much of subsection (2) of that Section as relates to forwarding a copy of the inspector's report to the registered office of the company shall apply in relation to an inspector appointed under this section as they apply in relation to an inspector appointed under Section 164 of that Act, but with the substitution for references to the company or other body corporate and its affairs of references to the manager under the scheme and to the administration of the scheme.

(4) The expenses of any investigation under the last foregoing subsection shall be defrayed by the Board of Trade out of moneys provided by Parliament.

FINANCE ACT, 1946 9 & 10 Geo. 6, Ch. 64

56.—(3) The Commissioners may, for the purpose of securing the stamp duties payable by virtue of this Part of this Act, by regulations require the trustees and the managers under unit trust schemes to keep such records of units thereunder, of the persons entitled to units thereunder, of transfers of units thereunder, and of the issue of certificates to bearer in respect of units thereunder, as may be specified in the regulations in relation to the trustees and the managers respectively, and if the trustees or managers under any such scheme fail to comply with any requirement of any such regulations, they shall incur a fine of ten pounds in respect of each matter which ought to have been but was not recorded.

UNIT TRUST RECORDS REGULATIONS

THE UNIT TRUST RECORDS REGULATIONS, DATED SEPTEMBER 27, 1946,
MADE BY THE COMMISSIONERS OF INLAND REVENUE UNDER SECTION 56 (3) OF
THE FINANCE ACT, 1946 (9 & 10 GEO. 6, C. 64)

1. *Citation*.—These Regulations may be cited as the Unit Trust Records Regulations, 1946.

2. *Interpretation*.—(1) In these Regulations references to the date on which a

* An amendment made by the Companies Act, 1948, has here been given effect to.—Ed.

person became the holder of any units are references to the date of the transfer of those units to him whether by virtue of the delivery to him of a certificate to bearer or by virtue of the execution of an instrument of transfer.

(2) The Interpretation Act, 1889(a), shall apply for the interpretation of these Regulations as it applies for the interpretation of an Act of Parliament.

3. *Preservation by trustees of certificates and instruments of transfer.*—(1) Every registered certificate and every certificate to bearer in respect of units under a unit trust scheme shall before issue be given a serial number by the trustees of the scheme and when surrendered by the holder shall be preserved by the trustees in such a manner as to enable reference to be made readily thereto.

(2) Every instrument of transfer in respect of units under a unit trust scheme shall, when delivered to the trustees of the scheme, be preserved by the trustees in such a manner as to enable reference to be made readily thereto.

4. *Record of units under scheme.*—The trustees of a unit trust scheme shall keep a record showing the number of units under the scheme representing the trust property, and from time to time as soon as any change occurs in the amount of such property they shall enter in the record the alteration in the number consequential on such change.

5. *Register of holders of registered units.*—The trustees of a unit trust scheme shall keep a register of the holders of registered units under the scheme and shall enter therein the following particulars:

- (1) The name and address of each person who holds any units under the scheme, the serial number of the certificate or certificates representing the units held by each such person and the number of units to which each such certificate relates.
- (2) The date or dates on which each such person became the holder of any units and the number of units of which he became the holder on each such date; and
 - (a) where he became the holder by virtue of an instrument of transfer, or in consequence of the surrender of a certificate to bearer, a sufficient reference to enable the instrument or certificate to be readily produced;
 - (b) where he became entitled to the units by operation of law, particulars of the name of the person from whom the right to such units was transmitted to him, and of the circumstances in which it was so transmitted or a sufficient reference to some other record kept by the trustees containing those particulars.
- (3) Where any person has ceased to hold any units the date or dates at which he ceased to hold them, and
 - (a) where he so ceased by virtue of an instrument of transfer, or in consequence of the issue of a certificate to bearer, a sufficient reference to the instrument of transfer to enable it to be readily produced, or as the case may be, a note of the serial number of the certificate to bearer;
 - (b) where his right to any units has been transmitted to another person by operation of law, particulars of the name of that person, and of the circumstances in which it was so transmitted, or a sufficient reference to some other record kept by the trustees containing those particulars.

6. *Register of certificates to bearer.*—(1) Where any units under a unit trust scheme are represented by a certificate to bearer, the trustees of the scheme shall enter in a separate part of the register referred to in Regulation 5 or in a separate register, the following particulars:

- (i) the fact of the issue of the certificate, and the serial number of the certificate;
 - (ii) the number of units included in the certificate; and
 - (iii) the date of the issue of the certificate.
- (2) Upon the surrender and cancellation of any certificate to bearer a note of the date of surrender shall be added to the entry.

7. *Loose-leaf records: index.*—(1) Registers or records required under these Regulations may be in loose-leaf form instead of in bound books provided that adequate precautions are taken to guard against falsification and ensure its discovery.

(2) Unless the register kept under Regulation 5 is in such a form as to constitute in itself an index, the trustees of the scheme shall keep in a convenient form an index of the names of the holders.

8. *Opening statement of units.*—(1) The managers of a unit trust scheme shall keep a statement of the units held by them at the opening of business on 1st August, 1946, showing separately the number represented by certificates to bearer and the number not so represented.

(2) Where it is claimed by the managers that any such units—

- (a) were not at any time before 1st August, 1946, held by any other person, and did not replace any units so held; or
- (b) were units of which they had before that date become the holders by virtue of an instrument or instruments of transfer executed within the immediately preceding two months; or
- (c) were units of which they had before that date become the holders by virtue of the transfer to them of a certificate or certificates to bearer within the immediately preceding two months,

they shall enter separately in the statement referred to in paragraph (1) of this Regulation the number of units held by them by virtue of instruments of transfer executed or certificates to bearer transferred to them before 1st June, 1946, the number of units falling under any of the foregoing headings (a), (b) or (c) respectively, and, as respects those falling under the headings (b) and (c), the number of units to which they became entitled on each day within the said two months on which any transfer took place.

9. *Daily record of transactions in units.*—(1) The managers of a unit trust scheme shall keep a record in which they shall enter separately under the following headings their transactions in units day by day on and after 1st August, 1946:

- (i) the number of units comprised in each transfer to the managers by an instrument of transfer or certificate to bearer. Each entry under this heading shall include a sufficient identification of the instrument of transfer or certificate to bearer;
- (ii) the number of units to which the managers become entitled in consequence of any addition to the trust property;
- (iii) the number of units comprised in each transfer by the managers of units to which no other person was entitled at any previous time and which do not replace units to which any other person was previously entitled;
- (iv) the number of units comprised in each transfer by the managers of units to which some other person was entitled at any previous time or which replace such units.

(2) Where an entry under the heading (iv) in paragraph (1) of this Regulation represents a transfer of any units previously entered under paragraph (2) of Regulation 8, or heading (i) of paragraph (1) of this Regulation, or a transfer of units replacing such units, the units comprised in the transfer shall be identified with the units included in the previous entry by a cross-reference to the previous entry and an addition to that entry showing the date of the transfer and the number of units included in that entry that are comprised in the transfer, or in such other manner as may be agreed by the Commissioners of Inland Revenue with the managers.

(3) On any units previously entered under paragraph (2) of Regulation 8 or headings (i) and (ii) of paragraph (1) of this Regulation being extinguished, the extinction shall be recorded by an addition to the appropriate previous entry showing the date of extinction, and, where part only of the units included in any such previous entry is extinguished, the number extinguished, or in such other manner as may be agreed by the Commissioners of Inland Revenue with the managers.

10. *Period of preservation of records.*—The registers, statements and other records and documents referred to in these Regulations shall be preserved during the life of the trust scheme and for a period of not less than one year thereafter:

Provided that nothing in these Regulations shall require instruments of transfer or registered certificates or certificates to bearer to be preserved for a period exceeding three years from the date on which they were finally delivered to the trustees of the scheme.

APPENDIX B

REPORTS OF CASES, THE DECISIONS ON WHICH ARE OF PROFESSIONAL INTEREST

THE LEEDS ESTATE BUILDING AND INVESTMENT SOCIETY, LTD.
v. SHEPHERD*

(Decided by STIRLING, J., in the Chancery Division, on 9th August, 1887)

Held to be an auditor's duty to see that accounts he certifies are actually correct. It was the duty of the auditor not to confine himself to verifying the arithmetical accuracy of the balance sheet, but to inquire into its substantial accuracy.

In 1869 the plaintiff company was formed and registered under the Act of 1862 for the purpose of dealing in lands and lending money on mortgage. In 1882 it went into voluntary liquidation.

By article 63 it was provided that when the company paid a dividend of 5 per cent. the directors were to receive 10s. for every meeting attended by them, and the remuneration was to be increased by 2s. 6d. for every additional 1 per cent. of dividend.

By articles 79 and 80 the directors were authorised to declare a dividend upon such estimate of profits as they might think proper to recommend, but no dividend was to be payable except out of profits.

Articles 86 to 89 provided that the directors should cause true accounts to be kept, and should lay before the company once in every year a statement of the income and expenditure, and also a Balance Sheet in the form prescribed by Table A of the Companies Act, 1862.

Articles 90 to 101 related to the auditing of the accounts and provided that the auditors should state in their report whether, in their opinion, the balance sheet was a full and fair balance sheet, properly drawn up so as to exhibit a true and correct view of the state of the company's affairs.

The articles also provided for the appointment of a manager and secretary, whose remuneration was to be fixed by the directors.

Except in 1876 the company made no profits during the whole period during which it carried on business.

This action was brought by the company in liquidation against the directors, the manager, and the auditor of the company to make them liable in respect of certain sums paid out of capital for dividends, and for fees and bonuses to the directors and manager respectively.

The balance sheets were false and misleading and contained fictitious items, and were framed with a view to the declaration of dividend. They were prepared by the manager and examined by the auditor. In examining the balance sheets the auditor was not furnished with a copy of the articles, and he did not comply with their provisions. The directors did not investigate the accounts, but trusted entirely to the manager and the auditor; and they did not know that the company had been paying dividends out of capital, or that the balance sheets were inaccurate. The balance sheets were not shown to the shareholders as required by the articles.

JUDGMENT

STIRLING, J., held, following *In re The Oxford Benefit Building and Investment Society* (56 L.J. Rep. Ch. 98), that the directors were bound to make good the several sums paid out of capital, and that the manager and auditor were liable for damages to the like amount. With reference to the case against the auditor, his lordship said that it was the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet, but to see that it was a true and accurate representation of the company's affairs. It was no excuse that the auditor had not seen the articles when he knew of their existence. The Statute of Limita-

* (1887) 36 Ch. 787; L.J. Notes (1887) 130.

tions had been pleaded on his behalf, and the plea had not been resisted, so that his liability would be limited to the dividends paid within six years of the commencement of the action.

LEE v. NEUCHATEL ASPHALTE CO. LTD.*

(Decided by COTTON, LINDLEY and LOPES, L.JJ., in the Court of Appeal, on 9th February, 1889)

Held, that where the shares of a limited company have, under a duly registered contract, been allotted as fully paid up shares in consideration of assets handed over to the company, it is under no obligation to keep the value of its assets up to the nominal amount of its capital, merely on the ground that no provision has been made for keeping the assets up to the nominal amount of the capital.

There is nothing in the Companies Acts to prohibit a company formed to work a wasting property . . . from distributing as dividend the excess of proceeds of working over expenses of working nor to impose on the company any obligation to set apart a sinking fund to meet the depreciation in the value of the wasting property.

The Court of Appeal delivered judgment in this important company case, which was argued before them on the 4th, 5th and 6th February, on an appeal by the plaintiff in the action from the decision of Mr. Justice Stirling. The action was brought by Mr. Charles John Lee, on behalf of himself and all of the ordinary shareholders of the Neuchatel Asphalte Company, against that company and the directors, one of whom, Mr. J. Varley, had been appointed to represent the preference shareholders of the company. The object of the action was to restrain the payment of a dividend of 9s. per share, proposed to be paid out of what were alleged by the defendants to be the profits of the company for the year ending 31st December, 1885. The company was on 9th July, 1873, incorporated under the Companies Act of 1862, with a capital of £1,150,000, divided into 35,000 preferred shares, and 80,000 ordinary shares, of £10 each respectively. One of the objects of the company, as defined by the memorandum of association, was to acquire, as from 1st July, 1873, and on the terms expressed in an agreement dated 17th July, 1873, a concession granted by the Government of the Canton of Neuchatel, in Switzerland, and held by the Neuchatel Rock Paving Company, and the exclusive right thereunder of getting the bituminous rock and mineral products from the Val de Travers, and also all the mines, works, business, property and assets of the last-mentioned company, and also all the concessions held by five other companies, and all the businesses, properties and assets of these various companies. The company had also power to work and get bituminous rock, according to any concession granted to the companies, and the product of any mines acquired by the company, and to sell and dispose of the same, and to carry on the business of manufacturers of asphalte and bituminous rock pavement in every branch, and also to grant concessions and establish subsidiary companies. The articles of association of the company provided that no distribution of profits—except an interim dividend not exceeding 7 per cent. on the preferred and 4 per cent. on the ordinary shares—should be made without the consent of a general meeting, whose decision was to be final in case of any dispute as to the amount of net profits; and it was provided by article 100 that the directors might, before recommending any dividend, set aside and invest out of the net profits of the company such sum as they thought proper as a reserved fund to meet contingencies or equalise dividends, or repair or maintain the company's works, but should not be bound to reserve moneys for the renewal or replacing of any lease or of the company's interest in any property or concession. The concession referred to in the agreement and in the memorandum of association was for a period of twenty years commencing 15th December, 1867, and ending 14th December, 1887, and conferred on the *cessionnaires* the exclusive right of working the asphalte mines within a certain defined area situate in the communes of Couvet and Travers, in the Canton of Neuchatel. The consideration for that concession originally consisted of a *minimum* annual rent of 40,000 fr. and a royalty of 19.75 fr. per ton of asphalte turned out; but for the 11 years between 16th December, 1870, and 16th December, 1881, these terms were modified as follows—there was to be

* (1889) 41 Ch. 1. *The Accountant* L.R. (1889) 26.

paid a *minimum* annual rent of 100,000 fr. and a royalty varying from 19.75 fr. to 5 fr. per ton. After 16th December, 1881, the parties were to return to the terms of the original concession. Soon after that concession had, with the consent of the Government of the Canton, been transferred to the Neuchatel Company, it appeared from the annual reports of that company that the terms of it began to be felt unduly burdensome to the company, and negotiations were entered into for the modification and extension of it, and ultimately these were effected by a convention agreed on in November, 1877, and finally adopted on 22nd January, 1878. The result of the modification of the royalty as applied to the actual working of the company between the beginning of 1878 and the end of December, 1885, was that the Government of Neuchatel had received about £39,000 less than would have come to it had the terms of the concession remained as they stood in 1873. The company had worked the mines and carried on business from its formation down to the present time. For the year ending 31st December, 1879, the accounts showed an excess of receipts over expenditure to the amount of £8,165 12s. 1d., and in respect of this year's working a dividend amounting to 2s. 6d. per share, and making £4,252 10s., was for the first time declared. All the subsequent accounts showed a like excess of receipts over expenditures to a considerable extent. Dividends were declared for the years 1881, 1882 and 1883 of 5s., 3s. 6d. and 5s. per share. In 1884 no dividend was declared, although the accounts showed a balance of £39,359 to the balance of the profit and loss account on 31st December, 1884; and this large sum was dealt with as follows—£1,000 was written off in respect of the sum paid for the modification and extension of the concession in 1877, and the balance of £38,359 was written off the cost in shares of the original concession and other assets taken over by the company on its formation. It appeared from the report for 1884 that the directors had resolved that the sum paid for the renewal of the concession should be written off at the rate of £1,000 a year. The accounts for the year 1885 showed an excess of receipts over expenditure to the amount of £17,140 13s. 2d., out of which, after setting aside a sum of £1,000 in reduction of the sum paid in 1887 for the renewal of the concession, it was recommended by the directors and resolved by a majority of the shareholders that a dividend on the preferred shares at the rate of 9s. a share should be paid. Mr. Justice Stirling, before whom the action was tried, dismissed the action, and the plaintiff now appealed.

JUDGMENT

The Court dismissed the appeal.

Lord Justice COTTON, in giving judgment, after stating the nature and objects of the respondent company, and referring to the fact that the assets of the respondent company consisted of the concession and the other subsidiary rights taken over from the previously existing companies, and that these assets had not been paid for in cash, said: Three points have been raised on behalf of the appellant. First, it was said that a principal part of the capital of the company had been lost. If by that it was meant that any part of the assets had been lost, in my opinion that is not correct, for the evidence shows that the assets of the company at present are of larger amount; its nominal capital, or, as I should prefer to call it, its share capital, is improved in value now to what it was when the company was formed in 1873, additional time for the concession to run having been obtained and less royalty having to be paid. Secondly, it was said that the property of the company was not sufficient to make good its nominal or share capital, and that the deficiency should be made up before any dividend ought to be paid. In my opinion, that argument is entirely wrong and involves a misapplication of the term 'capital'. 'Capital' is used in many senses, but the share capital of a company means the amount of its nominal capital divided into so many shares. The Companies Acts do not require, and it would be impossible that the assets of a company should be stated in its memorandum of association, though its share capital must be. No alteration can be made in the share capital of a company except in the manner provided for by the Companies Acts, and the share capital must not be applied except for some of the purposes for which the company was formed. But, in my opinion, there is no obligation on the company to make up the assets of the company so as to meet its share capital where the share capital has been issued under a duly registered contract, enabling allotment for something different

from cash. Of course, if the contract was fraudulent or illusory, it might well be that the shareholders would be bound to pay up, in cash, the difference; but there is no suggestion of anything of that kind here. The payment of the proposed dividend, therefore, is not a return of capital; it is not a return of money which the shareholders were bound to provide in order to make up the nominal amount of their shares. The third point raised was one of more difficulty; it was said that this concession being a wasting property, the payment of this dividend was dividing part of the capital of the company represented by this concession. It is a well-established principle of company law that the capital assets of a company must not be applied for any purpose not one of the objects of the company, and though there is nothing in the Companies Acts which says that dividends are not to be paid except out of profits—for the article to that effect in Table A in the Schedule to the Act of 1862 is merely a matter of internal regulation—yet it is well established that the paying of a dividend is not one of the objects of a company, and therefore that the capital assets of a company must not be applied in that way. If the directors were to sell what was a permanent property of the company and then declare a dividend, that would come within the principle laid down in *Guinness v. Land Corporation of Ireland* (L.R. 22 Ch.D. 349)—that the capital of a company cannot be applied for purposes not authorised. But that is not the case here, and we must take a reasonable and sensible view of the circumstances of this case. If it could be shown that this dividend was declared 'for the purposes of fraud, or for any other improper motive, and that . . . the company has thereby in effect taken away from its creditors a portion of the capital which was available for their debts', to use the words of Lord Justice Selwyn in *Stringer's case* (L.R. 4 Ch. App., at 488), then this Court would interfere to prevent such improper dealing. But when the Court sees that the directors of the company have acted fairly and reasonably in ascertaining whether this is in reality a part of the capital assets or not, then the Court is very unwilling to interfere with the discretion exercised by directors who have the management and regulation of the affairs of the company. In my opinion, it was not necessary, as Mr. Rigby suggested, that the directors should set apart each year a sum to answer the supposed annual diminution of this property by reason of its wasting nature. The Lord Justice then referred in detail to the cases of *Davidson v. Gillies* (L.R. 14 Ch.D. 347) and *Dent v. London Tramways Co.* (L.R. 16 Ch.D. 344), which, he said, were consistent both with each other and with the view which he took in the present case, and said that, having regard to the nature and constitution of this mercantile company, he was not satisfied that a proper provision had not been made for depreciation by the establishment of a reserve fund, and considered that it would be wrong for the Court to interfere to prevent the payment of the proposed dividend.

Lord Justice LINDLEY agreed. His lordship said the actual point to be decided is an easy one, but the difficulty arises from the fact that the Court is urged to lay down general principles of law which, if adopted, would paralyse the whole trade of the country. The respondent company was formed for the purpose of working certain asphalt mines of which it had got a lease. It was quite obvious that with respect to such a property every ton of stuff got out of that which was bought with capital represented a portion of capital. It was said that a division of the profit arising from the sale of such was a return of capital. If that was so, it is not, at all events, such a return of capital as is prohibited by the Company Acts. There is nothing in any of the Company Acts prohibiting anything of the kind. The only provisions in those Acts relating to capital were Sections 8, 12, 26, 28 and 34 in the Act of 1862; Sections 9-20 in the Act of 1867; and Sections 3-5 in the amending Act of 1877. There was nothing in any of those sections as to the mode of payment of profits or dividends. It has been very judiciously and properly left to the commercial world to settle how the accounts were to be kept. The Acts do not say what expenses are to be charged to capital account and what to revenue account. Such matters were left to the shareholders; they may or may not have a sinking fund or a deterioration fund, the articles of association may or may not contain regulations on these matters; if they do, the regulations must be observed; if they do not, the shareholders can do as they like so long as

they do not misapply their capital. In this case one of the articles provides that the directors shall not be bound to reserve moneys for the renewal or replacing of any lease or of the company's interest in any property or concession. Mr. Rigby says that that provision in the articles is contrary to law. Now, the Companies Act, 1862, does not require the capital to be made up if lost, and it does not prohibit payment of dividends so long as the assets are of less value than the capital called up, nor does it make loss of capital a ground for winding-up. The argument seems to be founded on the notion that the company is somehow a debtor to its capital; that may be a convenient notion from an accountant's point of view, but has nothing to do with law. Though the Acts do not say so, there are general principles of law which prohibit the capital of a company being applied for purposes other than those mentioned in the memorandum of association, and, further, if any of the purposes mentioned in the memorandum of association are expressly or impliedly forbidden by the statutes, then the capital of the company cannot be applied for those purposes (see *Trevor v. Whitworth* (12 App. Cas. 409)). But if a company is formed to acquire or work property of a wasting nature, e.g. a mine, quarry or patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, any excess of money obtained by working the property over the cost of working it may be divided among the shareholders; and this is true, although some portion of the property itself is sold, and in one sense the capital is thereby diminished. If it is said that such a course involves payment of dividends out of capital, the answer is that the Acts nowhere prohibit such a payment as is here supposed. The proposition that it is *ultra vires* to pay dividends out of capital is very apt to mislead, and must not be understood in such a way as to prohibit honest trading. It is not true, as an abstract proposition, that no dividends can be properly declared out of moneys arising from the sale of property bought by capital. But it is true that if the working expenses exceed the current gains, profits cannot be divided, and that if in such a case capital is divided and paid away as dividend, the capital is misapplied, and the directors implicated in the misapplication may be compelled to make good the amount misapplied. This was the case in *Rance's case* (L.R. 6 Ch. App. 104); in the *Oxford Benefit Building Society's case* (L.R. 35 Ch.D. 502); in *Leeds, &c., Investment Company v. Shepherd* (L.R. 36 Ch.D. 787); and in *Stringer's case* (L.R. 4 Ch. App. 475). In the present case the articles say that there need be no sinking fund; consequently, capital lost need not be replaced; nor, having regard to these articles, need any loss of capital by removal of bituminous earth appear in the profit and loss account of the working of the company's property. Our decision, therefore, in this case is quite consistent with the two cases before the late Master of the Rolls of *Davison v. Gillies* and *Dent v. London Tramways Co.*

Lord Justice LOPES: Very important questions are raised in this case. It is said by the appellants that a company is not to be at liberty to pay a dividend unless they can show that their available property at the time of declaring the dividend is equivalent to their nominal or share capital. In my opinion, such a contention is untenable. The nominal or share capital is diminished in value, not by means of any improper dealing with it by the company, but by reason of causes over which the company has no control or by reason of its inherent nature. That diminution need not, in my opinion, be made good out of revenue. In such a case a dividend may be paid out of current annual profits—out of profits arising from the excess of ordinary receipts over expenses properly chargeable to the revenue account, provided there is nothing contrary to the articles of association prohibiting such an application, and provided it is done honestly. If the contrary views were adopted, it might be successfully contended that where, owing to extraneous circumstances, the capital is increased in value, that increase might be dealt with as revenue profits and go to increase the dividend. That is contrary to all practice and to principle. It is said that where the capital is of a wasting character a sum must be laid aside to meet the depreciation, and that until such sum is laid aside there is nothing in the nature of profit divisible among the shareholders. The Lord Justice referred to the article providing that the directors should not be

bound to reserve moneys for the renewal or replacing of any lease or of the company's interest in any property or concession, and proceeded: Unless this article is *ultra vires* no question arises. Is the article *ultra vires*? I know of no obligation imposed by law or statute to create a reserve fund out of revenue to recoup the wasting nature of capital. Subject to any provision to the contrary contained in the articles, I believe the disposition of the revenue is entirely in the hands and under the control of the company. Provided there is by the company no infraction of the capital and nothing in the articles to the contrary, the disposition of the revenue is a matter of internal arrangement. I am unable to see in this that either capital or the product of capital has been dealt with in a way which is not authorised.

BOLTON v. NATAL LAND AND COLONISATION CO. LTD.*

(Decided by ROMER, J., in the Chancery Division, on 8th, 9th and 10th December, 1891)

Held that a company may declare a dividend out of current profits without being obliged to show that all its capital is intact

The fact that some portion of the capital of an incorporated company limited by shares has been lost, and not made good, affords no ground for restraining the payment of a dividend out of profits subsequently earned. The business of an incorporated company, limited by shares in the ordinary way, consisted mainly in buying, holding, cultivating, letting, selling and otherwise dealing with land in South Africa. In 1882 the company, under peculiar circumstances, debited their profit and loss account for that year with the whole loss occasioned by writing off a certain debt of over £70,000 as a bad debt, and *per contra* credited the same profit and loss account with a sum of nearly £70,000 in respect of an increase in value attributed (rightly or wrongly) to their lands (or a portion of them) in South Africa, above and beyond the cost price at which such lands previously stood in the books of the company, the result being to make the profit and loss practically balance each other upon the year's accounts. The company, having subsequently earned a working profit, declared a dividend thereout, in respect of the year 1885. Thereupon the plaintiff, in an action commenced in 1886 to restrain the payment of such dividend, contended that, at the time the value of the lands was written up in 1882, they were valued, and now stood in the company's books at an amount considerably exceeding their true value, and that, before a profit could be deemed to have been made which would be properly available for the payment of a dividend, the lands in question must be written down to their true value, and the difference debited to the profit and loss account, in the same way as the supposed increase had been credited to the profit and loss account for the year 1882.

JUDGMENT

Held that, assuming that a part of the capital had in fact been lost, and not subsequently made good, no sufficient ground was thereby afforded for restraining the payment of the dividend; that the fact of the company having written up the value of their land in 1882, and credited the increase to the profit of that year in the manner described, did not place them under any obligation to bring into account in every subsequent year the increase or decrease in the value of their lands; and that, having regard to the case of *Lee v. The Neuchatel Asphalte Co.* (61 L.T. Rep. N.S. 11; 41 Ch.D. 1), it was not correct, in estimating the profits of a year, to take into account the increase or decrease in the value of the capital assets of the company.

LUBBOCK v. THE BRITISH BANK OF SOUTH AMERICA LTD.†

(Decided by CHITTY, J., in the Chancery Division, on 1st April, 1892)

Held that if a company's articles of association so provide, a profit made on the sale of a part of the undertaking is available for dividend

This was a motion by the plaintiff, on behalf of himself and all others—the shareholders of the defendant company—to restrain the company from acting

* [1892] 2 Ch. 124; 92 L.T. 109.

† [1892] 2 Ch. 108; *The Accountant* L.R. (1892.) 56.

upon or carrying into effect a resolution passed by the directors of the company on 24th March last, and from placing a sum of £205,000 to the profit and loss account of the company, and from dealing with or distributing the same as if it were income of the company. It was stated that the company was incorporated in 1863 for the purpose of carrying on a banking business, with a capital of £1,000,000 divided into 100,000 shares of £10 each. All the shares of the company had been issued with £5 each paid up, constituting a paid-up capital of £500,000. The company had carried on business all over the world, but chiefly in America. Up to July, 1891, the name of the company was the English Bank of Rio de Janeiro, but in January, 1891, an agreement was entered into between the company and a Brazilian bank—namely, the Banco de Credito Universal (of Rio de Janeiro)—for the sale by the company of its goodwill and property in Brazil to the Brazilian bank for a sum of £875,000, and the company also agreed, on the payment of the £875,000, to discontinue the use of its name, and to adopt a name not indicating a bank doing business in Brazil, and the agreement contained provisions restricting the company from carrying on business in Brazil. At the end of June all the £875,000 was paid. In November the restriction against the company's carrying on business in Brazil was released by the Brazilian bank on payment by the company to the latter of £75,000. The £205,000 in question was the net balance of the £875,000, after deducting the £500,000 paid-up capital of the company, the £75,000 repayment, and divers sums for outgoings and compensation in reference to the sale to the Brazilian bank. On 24th March last a resolution was passed by the directors that the profit derived from the sale and repurchase of the bank's business in Brazil be treated as profit to be carried to the profit and loss account of the bank, and dealt with accordingly. It was stated that the present proceedings were of a friendly character, both parties being desirous of obtaining the opinion of the Court.

Mr. Whitehorne, Q.C., and Mr. S. Dickinson, in support of the motion, submitted that to carry over the £205,000 to a profit and loss account appeared to be *ultra vires* the company, as, according to the authorities, *Freres v. Bultfontein Mining Co.* (L.R. 1 Ch. 1891, 140), *Lee v. Neuchatel Asphalte Co.* (L.R. 41 Ch.D. 1, per Lord Justice Lopes, p. 26), a sum like the present, produced by the sale of part of the undertaking of the company, and not by earnings, should be treated as an accretion of capital to be placed to the capital account, and it was also argued that, having regard to the statements issued to the shareholders by the directors with regard to this particular fund, it was not competent for the directors to act on the resolution in question or carry the fund to the profit and loss account.

JUDGMENT

Mr. Justice CHITTY held that the £205,000 was plainly profit on capital, and not part of the capital itself, for that sum was the surplus ascertained on the assets' side after the liabilities and capital were placed on one side of the account and the assets on the other. Under the articles of the company the directors were justified in carrying over the £205,000 to a profit and loss account, and having appropriated to the reserve fund so much of the sum as they thought fit, they could distribute the remainder as dividends after an ordinary meeting called in pursuance of the articles had passed the requisite resolution.

VERNER v. THE GENERAL AND COMMERCIAL INVESTMENT TRUST LTD.*

(Decided by LINDLEY, KAY and SMITH, L.JJ., in the Court of Appeal, on 7th April, 1894)

Held that an injunction to restrain a company from paying a proposed dividend out of current profits on the ground that the capital of the company is not intact must be refused if the company is solvent and acting within its articles.

This was an appeal from a decision of Mr. Justice Stirling. It raised a very important question in company law—viz. whether, where there has been a loss in the capital of a company through depreciation in the value of its assets, the

* [1894] 2 Ch. 239; *The Times*. 8th April, 1894.

company is entitled to pay dividends out of profits earned by means of its investments without first reducing its capital so as to meet such depreciation. The action was brought by William Henry Verner, on behalf of himself and all other stockholders of the defendant company other than the directors, against the company and the directors. It came before the Court upon a motion by the plaintiff asking that the defendants might be restrained from declaring and from distributing among the members of the company any dividend in respect of the financial year of the company terminating on 28th February, 1894. The company was incorporated on 26th January, 1888, under a memorandum and articles of association, with a capital of £600,000 in 60,000 shares of £10 each, all of which had been issued and fully paid up in cash and converted into stock of two classes—preferred and deferred. In addition to its original share capital the company had borrowed £300,000 on the security of debenture stock, bearing interest at 4 per cent., and secured by a floating charge upon all the assets of the company. There had thus come to the hands of the company £900,000, which had been invested in various securities authorised by the memorandum of association. The present market value of such investments was only £654,776, showing a depreciation of £240,000. According to the evidence of the plaintiff it appeared that 'of such depreciation £75,000 or thereabouts represented the amount which there was no prospect of recovering within any reasonable period of time'. During the past year the receipts of the company in respect of income derived from their investments had exceeded the expenditure by upwards of £23,000. The question for the Court upon the motion was whether, there being a loss of capital to the amount of £75,000, and an excess of profits over expenditure of £23,000, a dividend could lawfully be declared and paid. The company was formed for the purpose of raising money and investing the same in various investments mentioned in the memorandum of association, and one of the objects of the company was 'to receive the dividends, income, profits, bonuses and advantages of every description from time to time payable or receivable in respect of the company's investments, and to apply the same respectively according to the provisions of the articles of association in force for the time being'. The articles provided: '(84) Subject to the rights of members holding share capital issued upon special conditions the receipts of the company from the dividends, income, profits, bonuses and advantages payable or receivable in respect of the company's investments shall be applicable as follows: First, to the payment of a dividend for the particular year at the rate of 5 per cent. per annum on the preferred stock; second, to the payment of such a dividend on the deferred stock as the same shall suffice to pay, and the trustees may, with the sanction of the company in general meeting, declare a dividend to be paid to the members accordingly. (85) The trustees may, before recommending any dividend, set aside out of the profits of the company such sum as they think proper as a reserve fund to meet contingencies, or for equalising dividends, or for any other purposes of the company; and may from time to time apply the whole or any part of such fund for any purposes of the company.' Mr. Justice Stirling, having regard to the nature of the constitution of this company, held that there was no legal obligation on the part of the company to make good the loss arising from the diminution in the value of the investments before declaring a dividend, and he dismissed the action. The plaintiff appealed.

The Court dismissed the appeal.

JUDGMENT

Lord Justice LINDLEY delivered the judgment of himself and Lord Justice A. L. SMITH as follows: **The broad question raised by this appeal is whether a limited company which has lost part of its capital can lawfully declare or pay a dividend without first making good the capital which has been lost. I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances. Such a proceeding may sometimes be very imprudent, but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles. We, however, have only to consider the legality or illegality of what is complained of.** As was pointed out in *Lee v. Neuchatel Asphalte Co.* (41 Ch.D. 1), there are certain provisions in the Companies Acts relating to the capital of limited companies; but no provisions whatever as to the payment of dividends or the division of

profits. Each company is left to make out its own regulations as to such payment or division. The statutes do not even expressly and in plain language prohibit a payment of dividend out of capital. But the provisions as to capital, when carefully studied, are wholly inconsistent with the return of capital to the shareholders, whether in the shape of dividends or otherwise, except, of course, on a winding-up, and there can, in my opinion, be no doubt that even if a memorandum of association contained a provision for paying dividends out of a capital such provision would be invalid. The fact is that the main condition of limited liability is that the capital of a limited company shall be applied for the purposes for which the company is formed, and that to return the capital to the shareholders, either in the shape of dividend or otherwise, is not such a purpose as the Legislature contemplated. But there is a vast difference between paying dividends out of capital and paying dividends out of other money belonging to the company, and which is not part of the capital mentioned in the company's memorandum of association. The capital of a company is intended for use in some trade or business, and is necessarily exposed to risk of loss. As explained in *Lee v. Neuchatel Asphalte Co.*, the capital even of a limited company is not a debt owing by it to its shareholders, and if the capital is lost the company is under no legal obligation either to make it good or, on that ground only, to wind up its affairs. If, therefore, the company has any assets which are not its capital within the meaning of the Companies Acts, there is no law which prohibits the division of such assets amongst the shareholders. Further, it was decided in that case, and, in my opinion, rightly decided, that a limited company formed to purchase and work a wasting property, such as a leasehold quarry, might lawfully declare and pay dividends out of the money produced by working such wasting property without setting aside part of that money to keep the capital up to its original amount. There is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, and in dividing the money annually yielded by it without preserving the capital sunk so as to be able to reproduce it intact either before or after the winding-up of the company. A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value. But in the absence of some special article or contract there is no law to this effect, and, in my opinion, for very good reasons. It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company either not in debt or well able to pay its debts from paying dividends so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk. Even a sinking fund to replace lost capital by degrees is not required by law. It is obvious that dividends cannot be paid out of capital which is lost; they can only be paid out of money which exists and can be divided. Moreover, when it is said, and said truly, that dividends are not to be paid out of capital, the word 'capital' means the money subscribed pursuant to the memorandum of association, or what is represented by that money. Accretions to that capital may be realised and turned into money and may be divided amongst the shareholders, as was decided in *Lubbock v. British Bank of South America* ([1892] 2 Ch. 199). But, although there is nothing in the statutes requiring even a limited company to keep up its capital, and there is no prohibition against payment of dividends out of any other of the company's assets, it does not follow that dividends may be lawfully paid out of other assets regardless of the debts and liabilities of the company. A dividend presupposes a profit in some shape, and to divide a dividend the receipts, say, for a year, without deducting the expenses incurred in that year in producing the receipts, would be as unjustifiable in point of law as it would be reckless and blameworthy in the eyes of business men. The same observation applies to payment of dividends out of borrowed money. Further, if the income of any year arises from a consumption in that year of what may be called circulating capital, the division of such income as dividend without replacing the capital con-

might or might not be paid by a company, regard was to be had to the constitution of the company and its articles. Lindley, L.J., at page 265, says: 'A company may be formed upon the principle that no dividend shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value, but in the absence of some special article or contract, there is no law to this effect.' Here there is no such contract with creditors, and it is, therefore, only necessary to consider the articles of association, which closely resemble those in Table A to the Companies Act, 1862. Article 117 provides that 'no dividend shall be payable except out of the profits arising out of the business of the company'. What are these profits? Upon this point his lordship referred at some length to the judgment of Lindley, L.J., in *Verner v. General Investment Trust* (*supra*) and continued: Apart from the use of the word 'profits' in article 117, there is nothing in the articles to show that the capital of the company (or, rather, assets of the value of those acquired by the company at its formation) must be kept up. Further, the articles appear to contemplate 'profits' as the excess of receipts over all expenditure properly attributable to the year. It is necessary, however, to consider whether the depreciation in goodwill and leaseholds is to be treated as loss of 'fixed' capital or of 'floating' or 'circulating' capital, and on this point I am of opinion that it is to be treated as loss of 'fixed' capital. It very closely resembles the loss which a railway company may be said to suffer if it be found that their line, which was made, say, ten years ago, at a certain cost, could now be made at a much smaller cost. Having regard to the remarks of Lindley, L.J., in *Lee v. Neuchatel Asphalte Co.* (*supra*), I think that the balance sheet cannot be impeached simply because it does not charge anything against revenue in respect of goodwill. I feel much more doubt whether £200 is a sufficient sum to allow in respect of depreciation of leaseholds, but I do not think under the circumstances that a case has been made out for an injunction, and the motion must be refused.

Re THE LONDON AND GENERAL BANK LTD.*

(Decided by LINDLEY, LOPES and RIGBY, L.JJ., in the Court of Appeal, on 6th August, 1895)

Held that an auditor is guilty of misfeasance who, when dissatisfied with the accounts of a company, does not plainly draw attention to the grounds for his dissatisfaction in his report.

JUDGMENT

Lord Justice LINDLEY: This is an appeal by Mr. Theobald, one of the auditors of the London and General Bank, which is being wound up, against an order made by Mr. Justice Vaughan Williams, under Section 10 of the Companies Act, 1890. By this order Mr. Theobald and the directors of the bank are declared jointly and severally liable to pay to the Official Receiver of the company two sums of £5,946 12s. 0d. and £8,486 11s. 0d., being respectively the amounts of dividends declared and paid by the bank for the years 1890 and 1891, with interest on those sums. The grounds on which this order was made on Mr. Theobald are that these dividends were paid out of capital, and that such payment was made pursuant to resolutions of the shareholders based upon recommendations of the directors of the bank and upon balance sheets prepared and certified by Mr. Theobald, and which did not truly represent the financial position of the company.

Mr. Theobald's appeal was supported by arguments to the effect: (1) that Mr. Theobald was not an officer of the company within the meaning of Section 10 of the Winding-up Act, 1890; (2) that the balance sheets and certificates given by Mr. Theobald were in accordance with the books of the bank, and that Mr. Theobald's duty as auditor was confined to framing the balance sheets, which showed the position of the bank as disclosed by its books; (3) that the dividends in question were not really paid out of capital and that, however imprudent and reckless it may have been to pay them, Mr. Theobald, as auditor, is not legally responsible for such payment; (4) that even if Mr. Theobald, as auditor, failed adequately to discharge his duty, and even if the dividends were paid out of

* [1895] 2 Ch. 166; *The Accountants* L.R. (1895) 173.

capital, his failure to discharge his duty was the remote and not the proximate cause of the non-payment of the dividends, and that he, consequently, is not legally liable to make good the amount so paid; (5) that at any rate the order is wrong in declaring him liable jointly and severally with the directors to repay the dividends in question.

The first of these contentions was argued and decided last April, and the Court then held that an auditor of a banking company governed by the Companies Act, 1879, and by such articles as regulated the present company, was an officer of the company within the meaning of Section 10 of the Winding-up Act, 1890, and was liable to have proceedings taken against him under that section. This point, having been thus decided, was, of course, not again raised, and nothing further need be said about it.

It remains, however, to consider what the duties of an auditor are as respects companies governed by the Companies Act, 1879, and by such articles as regulate this particular company. It will be convenient to do this before examining the facts relied upon by the liquidator as making Mr. Theobald liable to make good the dividends which he has been ordered to pay. Section 7 of the Companies Act of 1879, clauses 1, 5 and 6, are material. '7.—(1) Once at least in every year the accounts of every banking company registered after the passing of this Act as a limited company shall be examined by an auditor or auditors, who shall be elected annually by the company in general meeting.' Then clause 5 is: 'Every auditor shall have a list delivered to him of all books kept by the company, and shall at all reasonable times have access to the books and accounts of the company; and any auditor may, in relation to such books and accounts, examine the directors or any other officer of the company.' Then there is a proviso, which one need not read, about banks beyond the limits of Europe. Then 6 is: 'The auditor or auditors shall make a report to the members on the accounts examined by him or them, and on every balance sheet laid before the company in general meeting during his or their tenure of office; and in every such report shall state whether, in his or their opinion, the balance sheet referred to in the report is a full and fair balance sheet properly drawn up, so as to exhibit a true and correct view of the state of the company's affairs, as shown by the books of the company, and such report shall be read before the company in general meeting.' Then '7. The remuneration of the auditor or auditors shall be fixed by the general meeting appointing such auditor or auditors, and shall be paid by the company.' It is necessary also to read articles 106, 107 and 114. Article 106, which is under the head 'Accounts', runs thus: 'At every ordinary meeting the directors shall lay before the meeting a balance sheet showing the financial state of the company for the previous financial year, duly audited, and every such balance sheet shall be accompanied by a report of the directors as to the state and condition of the company, and as to the amount which they recommend to be paid out of the profits by way of dividend or bonus to the shareholders, after allowing for any interim dividend which the directors may have declared, and any sum which they may have set aside under article 116 hereof.' Then article 107, which is under the head 'Audit', runs thus: 'The accounts of the company shall be from time to time examined and the correctness of the statements shall be from time to time ascertained, by two or more auditors, in accordance with these presents.' Then article 114, which, I think, is the only further one I need read at this moment, runs thus: 'The auditors shall be supplied with copies of the statement of accounts intended to be laid before the meeting, and it shall be their duty to examine the same with the accounts and vouchers relating thereto.' These are the enactments and regulations which bear directly on the duties of the auditors, and although articles 107 and 114 are in terms more explicit than Section 7 of the statute as regards the duty of the auditors to examine and ascertain the correctness of the statements laid before them, and of the accounts laid before the shareholders, yet it is tolerably plain from the language of Section 7 of the Act, clause 5, that the articles add little, if anything, to the duties imposed on the auditors by the statute alone.

In connection with these articles, and in order to save repetition, it should be stated that by the articles of this bank it is the duty of the directors, and not of the auditors, to recommend to the shareholders the amounts to be appropriated for dividends; and it is the duty of the directors to have proper accounts kept so

as to show the true state and position of the company. Lastly, it is for the shareholders, but only on the recommendation of the directors, to declare a dividend.

It is impossible to read Section 7 of the Companies Act, 1879, without being struck with the importance of the enactment that the auditors are to be appointed by the shareholders, and are to report to them directly, and not to, or through, the directors. The object of this enactment is obvious. It evidently is to secure to the shareholders independent and reliable information respecting the true financial position of the company at the time of the audit. The articles of this particular company are even more explicit on this point than the statute itself, and remove any possible ambiguity to which the language of the statute, taken alone, may be open if very narrowly criticised.

It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce. Assuming the books to be so kept as to show the true position of the company, the auditor has to frame a balance sheet showing that position according to the books, and to certify that the balance sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. This is quite in accordance with the decision of Mr. Justice Stirling in *The Leeds Estate Company v. Shepherd* in 36 Chancery Division, page 802. An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not guarantee that his balance sheet is accurate according to the books of the company. If he did he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this.

Such I take to be the duty of the auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient; and in practice, I believe, business men select a few cases haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary, but still an auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion; and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.

Mr. Theobald's evidence satisfies me that he took the same view as myself of his duty in investigating the company's books and preparing his balance sheet. He did not content himself with making his balance sheet from the books without troubling himself about the truth of what they showed. He checked the cash, examined vouchers for payments, saw that the bills and securities entered in the books were correct, took reasonable care to ascertain their value, and in one case obtained a solicitor's opinion on the validity of an equitable charge. I see no trace whatever of any failure by him in the performance of this part of his duty.

It is satisfactory to find that the legal standard of duty is not too high for business purposes, and is recognised as correct by business men.

The balance sheet and certificate of February, 1892, that is, for the year 1891, was accompanied by a report to the directors of the bank. Taking the balance sheet, the certificate, and report together, Mr. Theobald stated to the directors the true financial position of the bank, and if this report had been laid before the shareholders, Mr. Theobald would have completely discharged his duty to them. Unfortunately, however, this report was not laid before the shareholders, and it becomes necessary to consider the legal consequences to Mr. Theobald of this circumstance.

A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms. Still, there may be circumstances under which information given in the shape of a printed document circulated amongst a large body of shareholders would by its consequent publicity be very injurious to their interests, and in such a case I am not prepared to say that an auditor would fail to discharge his duty if, instead of publishing his report in such a way as to ensure publicity, he made a confidential report to the shareholders, and invited their attention to it, and told them where they could see it. The auditor is to make a report to the shareholders, but the mode of doing so, and the form of the report, are not prescribed. If, therefore, Mr. Theobald had laid before the shareholders the balance sheet and the profit and loss account accompanied by a certificate in the form in which he had prepared it, he would perhaps have done enough, under the peculiar circumstances of the case. I feel, however, the great danger of acting on such a principle, and in order not to be misunderstood, I will add that **an auditor who gives shareholders means of information instead of information in respect of a company's financial position does so at his peril, and runs the very serious risk of being held, judicially, to have failed to discharge his duty.**

In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders in certifying and laying before them the balance sheet of February, 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words 'The value of the assets as shown on the balance sheet is dependent upon realisation'. The most important asset on that balance sheet is put down as 'Loans to customers and other securities, £346,975', and on those a full and detailed report was made to the directors, showing the very unsatisfactory state of these loans and securities, and it is impossible to read the oral evidence, the report of Mr. Balfour and Mr. Brock, dated the 22nd December, 1891, and the report of the auditor to the directors of the 3rd February, 1892, without coming to the conclusion that the entry of that large sum as a good asset without explanation was unjustifiable. It is a mere truism to say that the value of loans and securities depends upon their realisation. We are told that a statement to that effect is so unusual that the mere presence of those words is enough to excite suspicion. But, as already stated, **the duty of an auditor is to convey information, not to arouse inquiry, and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expresses no more than any ordinary person would infer without it.**

But Mr. Theobald relies on the fact that he was induced to omit from his certificate all reference to the report which he made to the directors because Mr. Balfour, the chairman, promised to mention such report in his speech to the shareholders, and he did so. But although Mr. Balfour twice alluded to the report, he did so in such a way as to avoid attracting attention to it. The second time he mentioned it was after a dividend had been declared, and when a motion to reappoint the auditors was before the meeting. The truth is that not a word was said to convey to the shareholders the substance of the information contained in the report, or to induce them to ask any question about it. The balance sheet and the profit and loss account were true and correct in this sense, that they were in accordance with the books. But they were, nevertheless, entirely misleading, and misrepresented

the real position of the company. Under these circumstances, I am compelled to hold that Mr. Theobald failed to discharge his duty to the shareholders with respect to the balance sheet and certificate of February, 1892. Possibly he did not realise the extent of his duty to the shareholders as distinguished from the directors, and he, unfortunately, consented to leave the chairman to explain the true state of the company to the shareholders instead of doing so himself. The fact, however, remains, and cannot be got over, that the balance sheet and certificate of February, 1892, did not show the true position of the company at the end of 1891, and that this was owing to the omission by the auditor to lay before the shareholders material information which he had obtained in the course of his employment as auditor of the company, and to which he called the attention of the directors.

But then it is contended that, even if this be so, there was, after all, no payment of a dividend out of capital; and further that, even if there was, still that such payment was not the natural or immediate result of Mr. Theobald's certificate, and of the accounts which he prepared.

Whether the payment was made out of capital or not is a question of fact. It was professedly made out of profits made by the bank by charging its customers with interest and commission on loans and discounts. The books showed such profit, but the question is, where did the money come from with which the dividends were paid? The money came from cash at the bankers or in hand, but this cash could not be properly treated as profit, and the directors and auditors knew this perfectly well. This part of the case has been most carefully investigated by the learned judge whose decision we are reviewing, and after attending most attentively to the observations of counsel on the reasonings and conclusions contained in the judgment appealed from, I see no reason whatever for dissenting from them. On the contrary, I entirely agree with him in saying that the profits for the year 1891 never really existed except on paper—that, to use his words, 'Whatever may be the right line to draw as to when profit not received may be carried to profit for the purpose of the annual revenue account, it is plain that there was no justification for so doing in the present case'. The real truth is that the assets of the bank were put down in the balance sheet at far too high a figure, and this entry, though not misleading if explained (as it was to the directors), was seriously misleading in the absence of explanation. Mr. Theobald says that he regarded the assets of the bank as only locked up, but his report and the schedule to it go far beyond this. The value of the principal asset depended on the probability of the Balfour group of companies and some of the other large borrowers repaying their loans. They were financing each other, their indebtedness to the bank increased largely during the year, the securities held by the bank for these loans were, to say the least, of very doubtful character, and yet the total amount due to the bank in respect of these loans is inserted in the balance sheet as a good asset without any deduction, and without a word of explanation to the shareholders. We now know that these assets have realised a comparatively small sum, and we were very properly warned against the danger of doing injustice by being wise after the event. But disregarding the result of realisation and attending only to what was known to the auditors in February, 1892, the entry in the balance sheet of the sum of £346,975 as a good asset was wholly unjustifiable unless explained.

We are now in a position to understand the true meaning of a passage contained in the auditors' report to the directors of the 3rd February, 1892, and which runs thus: 'We cannot conclude without expressing our opinion unhesitatingly that no dividend should be paid this year'. I find it impossible to treat this as a statement by the auditors that there are profits divisible among the shareholders, but that the auditors cannot recommend a dividend. I can only regard the passage as meaning that there are no funds out of which the dividend can properly be paid, and, therefore, no dividend ought to be paid this year. A dividend of 7 per cent. was, nevertheless, recommended by the directors, and was resolved upon by the shareholders at a meeting furnished with the balance sheet and profit and loss account certified by the auditors, and at which meeting the auditors were present, but silent. Not a word was said to inform the shareholders of the true state of affairs. It is idle to say that these accounts are so remotely connected with the payment of the dividend as to render the auditors legally irresponsible for such payment. The balance sheet and account certified by the auditors as

showing a profit available for dividend were, in my judgment, not the remote, but the real operating cause of the motion for the payment of the dividend which the directors improperly recommended. The auditors' account and certificate gave weight to such recommendation and rendered it acceptable to the meeting. It was wholly unnecessary for the Official Receiver to call a shareholder to say that he was induced by the auditors' certificate to concur in the resolution to pay a dividend. As to this part of the case, *res ipsa loquitur*.

The point was made that the form of the order was wrong. But there was nothing in this. Mr. Theobald could obviously be sued alone in an action at law for breach of his statutory duty as auditor, and the measure of damages would be the sum which he has been ordered to pay. Whether a similar action at law could be maintained against him and the directors jointly is more open to question. I am by no means satisfied that it could not, seeing that the wrongful payment of the dividend was caused by his improper certificate and accounts, and by the use made of them by the directors. But, be this as it may, there was a clear breach of trust by the directors, facilitated, and, indeed, only rendered possible by the auditor, who failed in discharging his own duty to the shareholders; and I have no doubt that in equity both he and they could be held jointly and severally liable for the misapplication of the company's moneys, which constituted a breach of trust. In respect, therefore, to the sum of £8,486 11s. wrongfully paid as dividend in 1892 in respect of the alleged profits made in 1891, the appeal in my opinion fails.

I pass now to the accounts and balance sheet prepared by the auditors in February, 1891, and showing the state of affairs in 1890. A profit for that year was shown and a dividend of £5,946 12s. was declared and paid, and Mr. Theobald has been held liable for this sum also. I agree with Mr. Justice Vaughan Williams in holding that the dividend for 1890 was in fact improperly declared and paid. But the evidence that Mr. Theobald was guilty of any breach of duty in certifying the accounts in February, 1891, is far less cogent than that which presses so heavily against him with reference to the accounts of February, 1892. The truth is that the conviction that the bank's affairs were every year getting worse and worse grew upon him year by year. This state of things was shown by the decrease of its reserve capital and the increase of its loans to customers. But the loans to customers were, speaking roughly, £100,000 less at the end of the year 1890 than at the end of 1891, and seeing that the accounts prepared by the auditors did accurately represent the position of the company as shown by the books, and that it is not proved that Mr. Theobald really knew, or ought then to have known, that the position of the bank was not correctly shown by the books, I think Mr. Justice Vaughan Williams has gone too far in holding Mr. Theobald liable for this sum. The reasons which induced the learned judge to decide that Mr. Theobald was not liable for the dividends paid in 1889 and 1890 appear to me to apply also to the dividends paid in 1891 in respect of the profits of 1890. No doubt the change made by the auditors in 1886 in the form of the certificate that they gave is really significant, and, unexplained, leads to the inference that the auditors did not believe that the books of the company and the balance sheet prepared from them correctly showed the position of the bank. But Mr. Theobald's evidence does, in my opinion, show that in February, 1891, matters were not known or believed to be so bad as to lead him to the conclusion that there were then no profits out of which a dividend could properly be paid. It is true that the position of the bank was very unsatisfactory in 1890, and the auditors knew it to be so. This, however, appeared from the balance sheet and accounts which they laid before the shareholders. It is known now that the assets were put down at too high a figure; but it is not proved that the auditors knew it or ought to have known it. The Balfour group of companies, though dependent upon each other, were by no means in so tottering a state as they were a year later. Mr. Wilkinson's debt was still treated by the directors as bearing interest and as a good, or at all events not a bad, debt. Mr. Benham's debt was unsatisfactory, but the auditors can hardly be blamed for treating it as good, having regard to the solicitor's statement as to the security held for it. This part of the case is very near the line, but having carefully considered it, I do not think that the evidence is sufficiently strong to establish a case of misfeasance on the part of Mr. Theobald in February, 1891. I am not satisfied that he was then guilty of more than an

excusable error of judgment; although now that all the facts are known the error is seen to have been very serious in its consequences. As to the sum of £5,946 12s. 0d., therefore, the appeal must be allowed. As regards costs, Mr. Theobald's appeal has resulted in reducing the sum for which he has been held liable; but, in other respects, and as regards his main contention, it has failed. Under these circumstances he ought not to receive or pay any costs of the appeal, and the only order as to costs will be that the Official Receiver be paid his costs out of the assets of the company.

Lord Justice LOPES has read and considered this judgment and concurs in it.

Lord Justice RIGBY: I have had the advantage of reading and considering the judgment just delivered by Lord Justice Lindley, and I might have confined myself to saying I concur in it, but as I have gone carefully into the evidence as against the appellant, I think that I shall do well to show how I have come to the conclusion on which my judgment is founded. I shall not attempt to repeat all that is contained in Lord Justice Lindley's judgment. Where no reference is made to a particular topic it must be taken that I have nothing to add, though I do not wish to detract from anything said. The appeal is against that part of the order of the 20th December, 1894, of Mr. Justice Vaughan Williams, which finds Mr. Theobald liable as one of the auditors of the London and General Bank Ltd. to make good to the assets of the company, jointly with other persons, and severally the amount with interest from the date of the order of two sums, £6,768 6s. 9d. and £9,328 17s. 4d., being the dividends with interest thereon down to the date of the order recommended by the directors and declared by meetings of the company in the years 1891 and 1892 for the years 1890 and 1891. I have not taken the same figures as Lord Justice Lindley did, because there has been added to the dividends the amount of interest down to the date of the order. I think it will be the exact figure.

The order was made on a summons taken out by the liquidator of the company in the matter of the Companies Acts and in the matter of the bank, asking, so far as is material for the present appeal, for a declaration of the joint and several liability of the directors and auditors of the company on the ground that the dividends before mentioned were not paid out of profits but out of capital, and so far as the auditors were concerned on the ground that they certified and reported that the balance sheets which were laid before the company at the said meetings purported to show profits in excess of the sum paid as dividends. I understand the application to have been in substance an application against the auditors as officers of the company under the 10th Section of the Act of 1890 to compel them to contribute to the assets of the company, by way of compensation for their misfeasance, such sums as the Court may think just.

The main issues, therefore, seem to be whether the auditors have been guilty of any misfeasance in relation to the company; whether the misfeasance has occasioned loss to the company for which compensation ought to be directed to be made. This will involve the question whether the dividends were, in fact, paid not out of profits, but out of capital, and whether such payment was the fault of the auditor. Then there will be the question of the amount of compensation which ought to be directed. To determine the first question, I think it will be necessary to consider in some detail the position and duties of the auditors, what they ought to have done, and what they have done. Then I refer to sub-section 6 of Section 7 of the Companies Act of 1879, and to those articles of association which have been referred to by Lord Justice Lindley. I do not think it necessary here to read them out. **The articles of association cannot absolve the auditors from any obligation imposed upon them by the statute, and it may be that they do not in this case impose any greater obligations as to the balance sheet, though they make it clear that similar obligations extend to all accounts placed before the company, including profit and loss account as well as the balance sheet. Under the statute, the members of the company are entitled to have the safeguard of an expression of opinion of the auditors to the effect, first, that the balance sheet is a full and fair balance sheet; and, secondly, that it, the balance sheet, is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs. The words 'as shown by the books of the company' seem to me to be introduced to relieve the auditors from any responsibility as to affairs of the company kept out of the books and**

concealed from them, but not to confine it to a mere statement of the correspondence of the balance sheet with the entries in the books. Now, a full and fair balance sheet must be such a balance sheet as to convey a truthful statement as to the company's position. It must not conceal any known cause of weakness in the financial position, or suggest anything which cannot be supported as fairly correct in a business point of view. The provision as to the balance sheet being properly drawn up so as to exhibit a correct view of the state of the company's affairs is taken from, though it does not go quite so far as, article 94, Table A, of the schedule to the Companies Act of 1862. Treated as an addition to the requisition of a full and fair balance sheet, it may not be easy to define the full extent of the obligation which it imposes, nor is it necessary to do so in this case, for it certainly requires, as will hereafter appear, a more detailed statement of facts, or a more detailed explanation of the affairs of the bank, than is contained in any of the balance sheets of this company.

It will be important to see what information the auditors actually acquired as to the business of the company, and the way in which they reported upon the successive balance sheets. Mr. Theobald and Mr. Timms were auditors of the bank from its incorporation in 1882, and they made the audit for successive years down to and including the audit for 1891.

The reports of the auditors to the members always took the form of a certificate or memorandum written on the balance sheet for the year. Their reports on the accounts for the years 1882 and 1883 contained a statement to the effect that in their opinion the balance sheet exhibited a true and correct view of the position of the bank. In their report on the accounts of 1885 a somewhat less emphatic statement to the same effect appears, but in the subsequent report no such statement is to be found. In a report to the directors dated the 11th February, 1886, which refers to the accounts for 1885, Mr. Theobald, after noticing that the first-class investments, kept by bankers for quick realisation in case of need, stood at a considerably reduced sum, and that more than the whole capital of the company was invested in four accounts, viz. the accounts of the Liberator, the Lands Allotment Co., the House and Land Co., and the Building Estates Co., and that these investments could not be easily realised in critical times, proceeds to say: 'You are doubtless aware that it is a rule with bankers to have at hand in cash or easily realisable securities an amount equal to at least one-third of the customers' current accounts. Considering the whole amount of uncalled capital, I consider that in this case the proportion is scarcely sufficient.' There can be no doubt that even at this time Mr. Theobald was aware that the state of affairs of the bank was unsatisfactory in the important points of lock-up of capital and consequent deficiency of realisable securities. At this date the cash in hand appeared to be £28,000—I only give the round figures—and the easily realisable securities were worth £12,600, making together £41,000 odd, while the current accounts and deposit accounts of customers together reached £107,000. I have not been able to distinguish the separate amounts of current and deposit accounts at that time. In the balance sheet for 1891, more particularly dealt with hereafter, the cash had fallen to £25,000, and the easily realisable securities to £7,820, making together £32,000 odd; hardly more than one-sixth of the sum due to customers on current accounts alone, which had increased to £189,000 odd, the amount due on current and deposit accounts taken together being £282,000. No other report of the auditors to the directors is put in evidence until that of 1892 as to the accounts of 1891. The report of the auditors to the members on the accounts for 1886 to 1890, both inclusive, are simply to the effect that the cash and bills receivable are correct, that securities had been produced for the investments and loans (no information being given as to the securities so produced) and that the balance sheet is a correct summary of the accounts recorded in the books. In the last-mentioned report is contained for the first time a statement, 'The value of the assets as shown on the balance sheet is dependent on realisation'.

Great stress has been laid on this by counsel for the appellants. They argue that it was sufficient to put members upon inquiry, and that from the course taken at the trial they were debarred from giving the evidence of experts as to the importance and signification of this. I may at once say that it was the duty of the auditors to convey in direct and express terms to the members any information which they thought proper to be

communicated, that the words of the statement are perfectly clear in their meaning, but also entirely unimportant, amounting to a mere truism, and that no evidence of experts would have been of the slightest use for the purpose of giving them a greater importance or signification than they possessed in themselves, even if such evidence were admissible. To me it appears that all the reports from 1886 onwards were imperfect, and that the auditors in giving reports in such form failed entirely to fulfil the statutory duties imposed upon them. Counsel for the appellants argued that such a failure would not amount to misfeasance but only to negligence, and that the appellant is not charged by the summons with negligence, but I cannot admit the cogency of this argument. The reports were made in order to fulfil the statutory obligation, and to be read to the meetings in accordance with the statute. Mr. Theobald, with reference to this matter, says at page 74 of the evidence, 'My evidence means the same as the Act'. Then he is asked, 'Do you say you could have given the certificate required by the Act of 1891?' (I think that question must have been meant and understood to mean, 'Could you have given the certificate for 1891 required by the Act?') '(A) Yes, certainly. (Q) Then why did you not do so? (A) Because I was not aware that it was considered necessary for me to give the certificate either in the words of the Act or not at all.' Mr. Theobald's interpretation of his own certificate cannot be received either in his favour or against him, and we should not unduly press against him apparent admissions made in the course of a very trying cross-examination. But this evidence of his does, I think, go so far as to show that the certificates were in fact given as reports under the Act, and independent of that evidence I think there can be no doubt that they were intended to be and were received and acted upon as reports under the Act.

I consider the giving of the certificates (assuming them to be to the knowledge of the auditors misleading certificates, a question which I shall deal with separately) to be a misfeasance within the meaning of Section 10 of the Act of 1890, and not a mere act of negligence; and that this was a fair meaning of the charge contained in the summons I can have no doubt, having regard to the terms of the certificates given and the explanations of Mr. Theobald himself, that there was a strong and growing feeling of dissatisfaction in the mind of Mr. Theobald at the state of the affairs of the bank as shown by the books, and I find no sufficient communication of the facts causing this dissatisfaction in the reports. The balance sheets when examined do not in my opinion fulfil the statutory requirements of being full and fair balance sheets, and they are not properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as shown by the books of the company. To establish this, I think it is necessary to give a short summary of the evidence, as to the years 1889, 1890 and 1891, the only years as to which we have sufficient evidence to be able to arrive at definite conclusions. From the tables set out at page 7 of the Official Receiver's report it appears that during the years 1889, 1890 and 1891, the greater part of the business of the bank consisted in making loans to and discounting bills for a group of companies, nine in number, conveniently referred to as the Balfour group, or the Balfour companies. Loans were also made or discounting facilities afforded to other companies allied to the Balfour companies, to certain directors of the bank, and customers, including Wilkinson and Benham, who are named in the table, by reason of special considerations affecting their accounts. These accounts of allied companies and the persons last mentioned are for convenience hereinafter referred to as 'the special accounts'.

The balances due from the Balfour companies at the end of the years 1889, 1890 and 1891 were, for 1889 £119,000, for 1890 £218,000, and for 1891 £308,000. Corresponding balances in the 'special accounts' were, for 1889 £77,000, for 1890 £112,000, for 1891 £121,000, the aggregate balances from the Balfour companies and on the special accounts being for 1889 £196,000, for 1890 £321,000, for 1891 £429,000. The corresponding balances due from all other customers and persons were, for 1889 £135,000, for 1890 £103,000, for 1891 £100,000. Roughly speaking, the proportion of what may be called the outside business that with the Balfour companies and on the special accounts was, at the end of 1889 two-thirds, at the end of 1890 one-third, and at the end of 1891 one-fourth. The paid-up capital increased in 1890 by about £67,000, and in 1891 by about £43,000, or altogether £120,000, but the whole of this, and considerably more than £100,000

in addition, had been absorbed into the accounts of the Balfour companies and the special accounts.

It has already been pointed out that the amount of cash and easily realisable securities at the end of 1891 was hardly more than one-sixth of the amount due to customers on current accounts, or about one-half of what Mr. Theobald had in 1886 pointed out to be required according to the usual practice of bankers.

These figures show an alarming absorption during the three years of the available assets of the company in advances to the Balfour companies and on the special accounts, and a perilous diminution of easily realisable assets. As is usual with banking companies, profits alleged to have been earned by the bank consisted, with unsubstantial exceptions, of interest on loans, discounting of bills, and commissions.

The gross profits entered in the books as having been earned from the Balfour companies, between the incorporation of the bank and the end of 1891, amounted to upwards of £84,000. The amount distributed in dividends during the same period was upwards of £58,000 and the amount carried to reserve fund £13,000. I include there £3,000 carried to reserve fund in accordance with the report on the accounts of 1891, making together £71,000.

The reserve fund, however, was not required by the articles of association to be kept separate, and was not kept separate from the general funds of the bank. It was employed in the bank's business, quite rightly, no doubt.

Subject to an argument as to appropriation of payments dealt with hereafter, the profits supposed to have been earned from the Balfour companies were not actually paid, but they were only debited in the accounts current of the different companies, and, speaking generally, the moneys owing by the different companies went on increasing from year to year. It is evident that, unless these profits could be fairly treated as not only earned but payable within a reasonable time, there would at the end of 1891 be no profits out of which a dividend could be paid, but, on the contrary, a large deficiency.

The learned judge, after a careful consideration and investigation of the evidence before him, has found, as a fact, that the credits of these companies at the end of each year were generally credits created temporarily for the purpose of audit, and that such credits, in the majority of cases, were created either by the discounting of bills of companies like Hobbs & Co., which bills constituted a mere paper asset, or by loans direct or indirect from the bank itself, the bulk of which were ill-secured.

I see no reason to differ from this conclusion, but it is a conclusion arrived at to an important extent from comparing the books of the bank with the books of other companies of the Balfour group to which the auditors had no access, and it is only to the extent to which it is founded on entries in the books of the bank itself that it can be used for the purpose of charging the appellant with knowledge of the facts, though it is very important on the question whether the dividends were really paid out of capital or not. The books themselves show that in many instances the accounts were put in credit in the manner described by the learned judge, but in other cases, and especially with reference to the indirect loans, that is to say, loans made by the bank to one of the companies out of which that company made an advance to another of the group for the purpose of putting the accounts of the latter in credit at the end of the year, the auditors would have no sufficient means of tracing the transactions.

Having made these general observations I will go on to examine more completely the important case of the accounts for the year 1891. For that purpose, as being more fair to the auditors, I will assume without at all deciding that, down to the end of 1890, no knowledge that the former balance sheets were misleading has been brought home to the auditors, and will endeavour to ascertain what additional information the auditors acquired during the audit for 1891. In the year 1891 the indebtedness of the Balfour companies to the bank as appearing by the bank books was increased by the sum of between £89,000 and £90,000 without any additional securities of importance being given, though, no doubt, to a considerable but unascertained extent money was expended on buildings already charged to the bank, which would make the property charged, though not necessarily the charges in favour of the bank, more valuable.

The securities consisted in the main of charges on buildings being constructed under building agreements, on which large sums had already been charged in

priority to the bank. The buildings were unfinished, and required further expenditure of very large sums before they could advantageously be disposed of, and in my judgment there was abundant evidence to show that these securities of the bank were very insufficient, and not realisable at all without the expenditure of further money, which the bank was unable to advance. The sums due on the special accounts had increased from £102,000 to £121,000, that is to say, between £18,000 and £19,000. With regard to these special accounts, I do not think it necessary to go in detail through the list, but I find that the auditors comment very unfavourably on the security for the following debts: That of William Blewitt for £7,849; that of Blewitt and Balfour for £2,148; and that of Balfour for £12,000. I think, however, that they may have considered the personal security in these cases sufficient, and I do not find anything on those cases. Wilkinson, at the end of 1890, was indebted to the bank in the sum of £24,000 practically unsecured. Mr. Theobald complained about interest being debited on the ground that the directors had then more definite information as to the security. This was going through the audit for 1890. The fact is that the security consisted of debentures of a tramway company whose tramway was never built. Interest accordingly ceased to be debited to this account in March, 1891. When Mr. Theobald was pressed to explain why the full sum was returned as an asset, he replied that it would have to be provided for out of the reserve fund. He further explained that he thought the account wanted watching, but that it was likely to turn out all right. In examination before the judge with reference to this debt, he said that he had conferred with the manager, who knew all about the circumstances. 'First of all', says he, 'I suggested the whole should be written off, but afterwards, Mr. Brock, I think it was, sent for Mr. Blewitt. We had a very serious conference about it, and they convinced me that the time had not come to do that (write off the whole), and they might yet get the whole of the amount back, but I thought it was not wise to charge interest.'

This, I think, falls very far indeed short of showing that the auditor believed, or could have believed, that the debt was a good debt, though it might have justified the carrying of it to a suspense account, instead of writing it off as bad. The importance of the case depends upon the fact that if the debt had not been entered in the balance sheet as a good debt, there would have been no profit at all to show for the year 1891. At the end of 1891, Mr. Wilkinson's debt, which had risen from discounting bills, all of which would appear by the dates to have been dishonoured, was reduced to £16,000 on account of discount by a loan of £10,000, but the indebtedness remained unaffected. With regard to Benham's debt, which increased in the year 1891 from £31,635 to £47,745, it was proved that in 1891 Mr. Theobald refused to pass the security for another year, and, to satisfy him, a letter purporting to come from Benham's solicitor, Mr. Waring, containing an undertaking to pay off £15,000 within a week, was produced. He had also been told, during the audit for 1890, that there was a security under a supposed will which had not been proved, and that they expected to get the will proved very soon. During the audit for 1891 he ascertained that the debt had increased from £31,000 to £47,000, that the £15,000 promised to be repaid had not been repaid, and that the alleged will had not been proved—indeed, it turned out afterwards that such a will never existed. The explanation of Mr. Theobald, that he trusted to the solicitor seeing that the security was all right, is not, under circumstances, altogether satisfactory, but I think it is safer to allow Mr. Theobald the benefit of the defence, though his own report sufficiently shows that he was not himself thoroughly satisfied. I wish to make it plain, so far as I can, that I am only relying on matters which Mr. Theobald ought to have known and must be presumed to have known. The debt of £7,300 from the Medway Portland Cement Co. had, like Wilkinson's, ceased to be charged with interest, and could not properly have been treated as a fund for the payment of dividend. With reference to that of the Public Works Co. Ltd., amounting to £8,105, the auditors, in their schedule to their report to the directors, say this: 'The realisation of this is very doubtful.' There could, therefore, be no justification for treating this as a fund for payment of dividend. Whilst Mr. Theobald was engaged upon the audit of the accounts for 1891, or previously, a report of Messrs. Balfour & Brock, dated 22nd of December, 1891, was produced to him as to the way of putting into credit current accounts of Hobbs & Co. Ltd., George Newman & Co. Ltd., the London, Edinburgh & Glasgow

Insurance Co., and C. H. Wilkinson, by loans from the bank. With reference to Mr. Wilkinson's account, the proposal 'that the overdraft should be made in part by a loan and in part by fresh acceptances of both secured as may be arranged, we think the further loan should be £10,000 on loan and £15,000 on bills'. The loan was made, and, apparently, £16,000 was left on security of acceptances, but it does not appear that any security was then arranged for or given, or that Mr. Theobald investigated this matter. Attention was, therefore, called in this particular case to the mode in which the accounts were put in credit as found by the learned judge. Several facts which appear to me to be most material with reference to the debt of 1891 are to be gathered from the text of the report. I have dealt, to a certain extent, with the schedule in the remarks I have previously made, but as to the text of the report of the auditors of February, 1892, almost every sentence is full of serious meaning. In it they state 'that they are unable to give a more satisfactory certificate than the one set forth', which is a mere statement that the balance sheet is a correct summary of the accounts as recorded in the books, followed by a statement that the value of the assets as shown on the balance sheet is dependent upon realisation, which I have already commented upon, an important sentence: 'On this subject we have reported specifically to the board.' This may mean they have reported as to the value of the assets, or as to their realisation, or (as I think is the true construction) as to both. The auditors were induced to withdraw this sentence, which, though it would have given no information of the slightest value to the members, yet would have been calculated to put them upon inquiry. They go on: 'We are not qualified, nor is it the province of the auditors, to estimate with exactitude the value of the securities.' The words 'with exactitude' seem to me to be emphatic, and to point out that they had, as appears by the report, made a general estimate of the securities, which was very unfavourable. They say, 'Nevertheless, we feel it our duty to send you herewith a schedule of the securities amounting to £487,000, which we desire should have the special and very serious consideration of the directors.'

In the £487,000 are included every one of the sums owing by the Balfour companies and on the special accounts, and nearly £60,000 more out of the £100,000 owing by other customers of the bank. Auditors who feel it their duty to call the special and very serious consideration of their directors to £487,000 out of a total of £530,000 of the debts due to the bank must indeed have arrived at the opinion that the state of affairs of the company was critical and dangerous, but, as will appear, Mr. Theobald does not deny this, though he attempts, unsuccessfully, I think, to explain it away by saying that all his anxiety arose from the fact of the assets being locked up. Further on in the report the auditors say, 'The gravity of the situation is enhanced by the fact, as we believe it to be, that the board is in many cases powerless to decline further help because they are powerless to realise'. This appears to me to be a very just but a very serious statement. The Balfour companies were indeed so much bound up with one another by a system of inter-financing, and some of them had committed themselves so deeply in the building schemes of Hobbs & Co., Newman & Co. and others, that they would only be kept going in the future, as they had been in the past, by continued advances from the funds of the bank. The last quoted extract from the report seems to me to show that the auditors fully appreciated this view of the state of affairs of the company. They continue as follows: 'We beg also respectfully to point out that the quarters from which the bank obtains by far the larger proportion of its business'—meaning, I conclude, the Balfour companies, and some of the special accounts—'are such that the constitution of the board must make it difficult, if not impossible, to obtain a sufficiently independent judgment upon many vital questions which have to be decided in its management.' No doubt this refers to the fact that some members of the board of the bank, the financing company, were members also of the board of different Balfour companies requiring advances, and the difficulty arising from this is obvious and serious. Then follows a sentence which forms an appropriate ending to such a report: 'We cannot conclude without expressing the opinion unhesitatingly that no dividend should be paid this year.' The auditors were, unfortunately, persuaded by Mr. Balfour, assisted by Mr. Brock, to strike out this clause, I believe, before the report reached the hands of the other directors of the bank. Mr. Theobald explains this by saying that he came to the conclusion that it was beyond the province of

the auditors to express an opinion as to the policy of declaring a dividend, and if that were all, I should be disposed to agree with him. **It is no part of the auditors' duty to consider what is good or what is bad policy. They have only to examine into facts and see that the members have their opinion as to the balance sheet showing the state of affairs of the company.** But the context seems to oblige me to read the excised sentence as meaning not that it was impolitic, but that it would be improper, having regard to the state of affairs of the company, to declare a dividend. Having regard to the explanations given by Mr. Theobald in his evidence, I think the postscript to this report very significant. It runs thus: 'We do not wish it to be understood that we consider all the accounts in the schedule are unsecured, but as a whole the capital therein represented is locked up.' That is the defence, that all their alarm arose from the capital being locked up. This is not, I think, the language that would have been used if the auditors had thought that the only mischief was in the locking-up, and an examination of the schedule to my mind confirms this conclusion. To a great extent the memoranda in the schedule explain themselves, and I have already dealt with many of the items. The accounts of each one of the Balfour companies is referred to in such a way as to show the unsatisfactory state of the securities. Mr. Theobald now says that he had no doubt as to the solvency of any of the Balfour companies, and in a certain sense I am ready to believe this; that is to say, he thought that if they continued to be financed in the future as they had been in the past, and so were enabled to complete the buildings which had been commenced, they might ultimately be able to repay the advances to them with interest and commission. But this is not the meaning of solvency in a legal or business sense, and it is quite plain that Mr. Theobald knew perfectly well that some at least of these companies were, and were likely to remain for an indefinite period, unable to meet their liabilities as they became due. In no other way can the memoranda as to the want of security, or the defective nature of the securities, of the several Balfour companies be explained. Similar observations apply to the memoranda as to the special accounts. Notwithstanding this report, every item of the £487,000 was entered as a good debt in the balance sheet for 1891. No valuation was made of any one of the debts, or of the securities for them. If any such valuation had, in fact, been made, I think it plain that there could have been no profit shown for the year. Mr. Theobald gave evidence several times over to the effect that whilst he was engaged in the audit for 1891 he felt that it was a very important crisis in the bank's affairs, and that if they could only get over the next month or so they would save it. His explanation of his withdrawal of the words in the proposed report to the members is that on this point he had reported specifically to the board. In explanation he gave, among other carefully prepared and considered reasons, the following: That 'Mr. Balfour was so thoroughly aroused to the necessity for taking the affairs of the bank resolutely in hand as to lead me to believe that he would do so, and being a man of great financial resource, he would be able to save the bank'; and that Mr. Balfour also spoke of an amalgamation. 'Mr. Balfour said that, while doing this, he would confer with me continuously, and that no interim dividend should be paid without consultation with me.' The first intimation received of payment of the interim dividend was an announcement in the Press of an interim dividend for 1892, for which it is not suggested Mr. Theobald was in any way liable. This would have given twelve months to work, during which time it would have been quite possible for Mr. Balfour to obtain very large repayments from the borrowing companies with which he was connected, and thus for the bank to be saved. That is a very important point to make.

In another place he says, 'My main point is this, that the bank could be saved if many of these accounts were collected. Mr. Balfour had absolute power over most of these companies, and he was so thoroughly alarmed that I quite believed that if we could only tide over that period he would use his influence over other companies to bring the money into the bank. I quite imagined he would do that, even if it meant that some of the other companies would have to go to the wall.' What becomes of his statement that he thought the companies were solvent? He says it is a critical time; if you can tide over the next month or two—as to which he never expresses an opinion—if you can do that, then the resources of Mr. Balfour are so great, his influence with the other companies so great, that it is quite possible he may collect a number of the accounts, even if the other com-

panies have got to go to the wall. I think it is impossible to avoid the conclusion that Mr. Theobald, when about to make his report on the accounts of 1891, was thoroughly alarmed at the critical position of the bank, as he thought it more than likely the bank would not tide over another month or two, but that if it did, it could only be saved by extraordinary exertions on Mr. Balfour's part, and that in the process some of the other Balfour companies might have to go to the wall. He represents Mr. Balfour as fully sharing his alarm. If we turn to the balance sheet to see whether the state of the company's affairs, as apprehended by Mr. Theobald, was in any way indicated therein, we shall, I think, be obliged to answer the question in the negative.

The liabilities appear to be sufficiently set forth. It is the statement of the assets which most calls for criticism. The cash at the bank was correctly stated and so are the bills receivable, though the amount of £180,000 there appears only to have been arrived at by transferring £58,000, on 31st December, 1891, from bills receivable to a loan account for unpaid expenses. Disregarding the small item for stamps, the only other items on the credit side are as follows: 'Investments including reserve fund'—the reserve fund at that time was £10,000—'2½ per cent. Consols and Prescott and Arizona Railway bonds, £7,820'. That could not be the investments which included the reserve fund of £10,000. 'Loans to customers and other securities, £346,000.' In the two items, 'bills receivable' and 'loans to customers and other securities', are, as above pointed out, included the whole of the sums, amounting to £487,000, the subject of the report of the auditors to the directors, at their full value. This item, 'loans to customers and other securities', is, of course, altogether inaccurate and may be very misleading. What the £346,000 really consists of is 'loans to customers partly secured', which is a very different matter. It would be open to any ordinary reader of the balance sheet to suppose that there were securities to an indefinite amount apart from loans to customers, and available to meet moneys due on the current accounts of customers. I am at a loss to understand for what purpose this item could have been so entered. It was not through inadvertence, for it was a correction of a still more misleading entry occurring in former balance sheets. It was suggested that such an item frequently appears in balance sheets. It may be so for anything I know, but it is none the less improper in the particular balance sheet which we have to consider. In short, the balance sheet, as it stands, would have given no hint to any ordinary reader of the critical position arising either from the locking-up of capital or from the doubtful nature of many of the debts entered at their full value. In reporting this balance sheet without explanation the auditors were, in my judgment, guilty of a misfeasance within the meaning of the 10th Section of the Act of 1890, as charged in the summons, and were in this case, at any rate thoroughly alive to the unsatisfactory state of the affairs of the bank as shown by the books. The next question is whether the misfeasance was the cause of loss to the company. On examination of the evidence there set forth, I should be led to the conclusion that the auditors did not know that a dividend could not properly be paid out of profits.

See how the figures stand from another point of view. The profit and loss account shows a gross profit of £24,000. After making provision for bad and doubtful debts, and after deduction of £6,600 for expenses of management and other charges, there is carried over to the balance sheet a net profit of £18,000 odd, out of which there had already been applied £6,000 and more in payment of an interim dividend, leaving a balance of between £11,000 and £12,000 and nothing more. £3,000 of that was to be carried to reserve; so you have only about between £8,000 and £9,000, according to the books, for dividend. But of the gross profits for the year 1891 shown by the books £16,788 were book entries debited to the Balfour companies, £2,462 a book entry debited to Benham's account, and £275 a book entry debited to Wilkinson's account. That, of course, was in the early part of the year, Wilkinson's account being treated as a debit. Assuming all the Balfour companies, and Benham and Wilkinson, to have been able to pay the whole sums due from them, except the amount debited in 1891 for interest and commission, not only the profits available for dividend would be swept away, but of the reserve fund itself little or nothing would be left. Such an assumption however, in my judgment, would have been extravagantly favourable to the

auditors, and it only required that one of the debts owing by Mr. Wilkinson (I leave out Benham because I do not want to found on Benham any charge against Mr. Theobald), or almost any one of the Balfour companies should turn out to be bad, it would exhaust everything belonging to the bank which was not capital. It turned out that each of the Balfour companies as well as Wilkinson and Benham, as well as other debtors of the bank, were insolvent. In my judgment it is established that the bank had no funds out of which the dividends could in any point of view be properly paid. I think the auditors might well be held to have known, but I do not rely upon that conclusion in my judgment; what I do rely upon is that the auditors must have known and did know that the balance sheet was not properly drawn up so as to show the state of affairs, and that was a misfeasance. If they were guilty of misfeasance in relation to the company, they must be responsible for the consequences of such misfeasance, whether they had arrived at the conclusion that the dividend if paid at all would be payable out of capital or not. That dividends were, in fact, paid out of capital cannot, I think, be doubted. It was argued that before the stoppage of the bank the profits entered in the 1891 balance sheet were, in fact, paid by appropriation of moneys paid into current accounts. This would not apply to a case like Wilkinson's, where there was no current account, but in my judgment the rule in *Clayton's* case has no sort of application under the circumstances. If it had, a bank might always pay profits by mere book entries, though the customers against whom interest and commission were charged might all be hopelessly insolvent. Was, then, the loss occasioned by the misfeasance of the auditors? It has been argued that the payment of the dividend was not the proximate result of the auditors' report, as the recommendation of the directors and the vote of the meeting had to intervene. This appears to me to misrepresent the true state of things. The report of the auditors was a continuing representation, made indeed before, but in law and in good sense to be treated as repeated after, the recommendation of the directors. It was perfectly well known to Mr. Theobald (at any rate at the meeting where he was present and heard the reading of the report recommending a dividend, and the speech of Mr. Balfour) that this report was intended to be relied upon as justifying the recommendation and as an invitation to vote the dividend. How far the judgment should go against the appellant has given me considerable difficulty. A great deal of the reasoning which has led me to hold that their reporting on the accounts of 1891 is a misfeasance in relation to the company applies only to the case of that report. The learned judge has held Mr. Theobald liable not only for the 1891, but also for the 1890, dividend. I am far from saying that he is clearly wrong, but I cannot satisfy myself that he is clearly right. In the case of the 1890 dividend it cannot, on the evidence, be made out to my full satisfaction that the auditors knew the balance sheet to be substantially misleading, and I think it safer to confine the order to the dividend in respect of 1891.

Lord Justice LINDLEY: The order will stand as to one dividend with interest but not as to the other.

THE KINGSTON COTTON MILL CO. LTD.*

(Decided by LINDLEY, LOPES and KAY, L.JJ., in the Court of Appeal, on 19th May, 1896)

Held that in the absence of suspicious circumstances an auditor is not guilty of negligence who relies upon the statements made by trusted officers of the company.

This was an appeal by Messrs. Benjamin Pickering and Arthur Edgar Peasegood, the former auditors of the company now in liquidation, against an order of Mr. Justice Vaughan Williams under Section 10 of the Companies (Winding-up) Act, 1890, making them liable to make good to the assets of the company moneys of the company improperly applied in payment of dividends on the faith of certain balance sheets certified by them. The facts in the case were fully reported in Volume XII, *The Accountant Law Reports*, p. 225.

The appeal was argued on 6th, 7th and 8th May.

Their lordships now delivered judgment, allowing the appeal.

Lord Justice LINDLEY said: This is an appeal from an order made by Mr. Justice

* [1896] 1 Ch. 6; *The Accountant L.R.* (1896) 77.

Vaughan Williams under Section 10 of the Companies (Winding-up) Act, 1890, on Mr. Pickering and Mr. Peasegood, the auditors of the company, ordering them to pay to the liquidator certain sums of money, being the amounts of dividends improperly declared and paid out of the assets of the company on the faith of certain balance sheets prepared and signed by the auditors. The appeal is made upon two grounds: (1) that the auditors have not failed to discharge their duty to the company and are under no liability to make good the money misapplied; (2) that even if they have, the proper remedy is by action and not by the summary process to which the liquidator has had recourse. It will be convenient to dispose of the second point first. It has already been decided that the auditors of this company are 'officers' within the meaning of Section 10 of the Companies (Winding-up) Act, 1890 (see [1896] 1 Ch. 6; *The Times Law Reports*, Vol. XII, p. 60). The object of that section is the same as that of Section 165 of the Companies Act, 1862, which it has replaced. That object was to facilitate the recovery by the liquidator of assets of a company improperly dealt with by its promoters, directors, or other officers. The section applies to breaches of trust and misfeasance by such persons. I agree that the section does not apply to all cases in which actions by the company will lie for the recovery of damages against the persons named; it is easy to imagine cases of breach of contract, trespasses, negligences, or other wrongs to which the section is inapplicable, and some such have been the subject of judicial decision; but I am not aware of any authority to the effect that the section does not apply to the case of an officer who has committed a breach of his duty to the company, the direct consequence of which has been a misapplication of its assets, for which he could be made responsible by an action at law or in equity. Such a breach of duty, if established, is a 'misfeasance' within the meaning of the section, or, to adopt the language used in *Cavendish-Bentinck v. Fenn* (12 A.C. 652), such a breach of duty is a misfeasance in the nature of a breach of trust. This view of the section was adopted by this Court in *In re The London & General Bank* ([1895] 2 Ch. 166, 673; *The Times Law Reports*, Vol. XI, pp. 374-573), and is, in my opinion, correct. On this preliminary point, therefore, which, however, does not touch the merits of the case, the appellants are not entitled to succeed. I come now to the real question in this controversy, and that is, whether the appellants have been guilty of any breach of duty to the company. To decide this question it is necessary to consider: (1) What their duty was; (2) How they performed it, and in what respects (if any) they failed to perform it. The duty of an auditor generally was very carefully considered by this Court in *In re The London and General Bank* ([1895] 2 Ch. 673), and I cannot usefully add anything to what will be found on pages 682-684. It was there pointed out that an auditor's duty is to examine the books, ascertain that they are right, and to prepare a balance sheet showing the true financial position of the company at the time to which the balance sheet refers. But it was also pointed out that an auditor is not an insurer, and that in the discharge of his duty he is only bound to exercise a reasonable amount of care and skill. It was further pointed out that what in any particular case is a reasonable amount of care and skill depends on the circumstances of that case; that if there is nothing which ought to excite suspicion, less care may properly be considered reasonable than could be so considered if suspicion was or ought to have been aroused. These are the general principles which have to be applied to cases of this description. **I protest, however, against the notion that an auditor is bound to be suspicious, as distinguished from being reasonably careful. To substitute the one expression for the other may easily lead to serious error.** I pass now to consider the complaint made against the auditors in this particular case. The complaint is that they failed to detect certain frauds. There is no charge of dishonesty on the part of the auditors. They did not certify or pass anything which they did not honestly believe to be true. It is said, however, that they were culpably careless. The circumstances are as follows: For several years frauds were committed by the manager, who, in order to bolster up the company and make it appear flourishing when it was the reverse, deliberately exaggerated both the quantities and values of the cotton and yarn in the company's mills. He did this at the end of the years 1890, 1891, 1892 and 1893. There was no book or account (except the stock journal, to which I will refer presently) showing the quantity or value of the cotton or yarn in the mill at any one time. It

would not be easy to keep such a book. Nor is it wanted for ordinary purposes. There is considerable waste (20 or 25 per cent. on the average) in the manufacture of yarn from cotton, and the market prices of both cotton and yarn are subject to great fluctuations. The balance sheets of each year contained on the asset side entries of the values of the stock-in-trade at the end of the year, and those entries were stated to be 'as per manager's certificate'. There were also in the balance sheets entries on the opposite side of the values of the stock-in-trade at the beginning of the year. The quantities did not appear in either case. The auditors took the entry of the stock-in-trade at the beginning of the year from the last preceding balance sheet, and they took the values of the stock-in-trade at the end of the year from the stock journal. The book contained a series of accounts under various heads purporting to show the quantities and values of the company's stock-in-trade at the end of each year, and a summary of all the accounts showing the total value of such stock-in-trade. The summary was signed by the manager, and the value as shown by it was adopted by the auditors and was inserted as an asset in the balance sheet, but 'as per manager's certificate'. The summary always corresponded with the accounts summarised, and the auditors ascertained that this was the case. But they did not examine further into the accuracy of the accounts summarised. The auditors did not profess to guarantee the correctness of this item. They assumed no responsibility for it. They took the item from the manager, and the entry in the balance sheet showed that they did so. I confess I cannot see that their omission to check his returns was a breach of their duty to the company. **It is no part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade in hand. In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the balance sheet.** In this case the auditors relied on the manager. He was a man of high character and of unquestioned competence. He was trusted by everyone who knew him. The learned judge has held that the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade in hand, and they trusted him accordingly in that matter. But it is said they ought not to have done so, and for this reason. The stock journal showed the quantities—that is, the weight in pounds—of the cotton and yarn at the end of each year. Other books showed the quantities of cotton bought during the year and the quantities of yarn sold during the year. If these books had been compared by the auditors they would have found that the quantity of cotton and yarn in hand at the end of the year ought to be much less than the quantity shown in the stock journal, and so much less that the value of the cotton and yarn entered in the stock journal could not be right, or, at all events, was so abnormally large as to excite suspicion and demand further inquiry. This is the view taken by the learned judge. But, although it is no doubt true that such a process might have been gone through, and that, if gone through, the fraud would have been discovered, **can it be truly said that the auditors were wanting in reasonable care in not thinking it necessary to test the managing director's returns? I cannot bring myself to think they were, nor do I think any jury of business men would take a different view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to anyone before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential. I cannot think there was.** The manager had no apparent conflict between his interest and his duty. His position was not similar to that of a cashier who has to account for the cash which he receives, and whose own account of his receipts and payments could not reasonably be taken by an auditor without further inquiry. The auditor's duty is not so onerous as the learned judge has held it to be. The order appealed from must be discharged with costs.

LOPES, L. J., in the course of his judgment, made the following observations upon the duties of auditors: **It is the duty of an auditor to bring to bear on the**

work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but, in the absence of anything of that kind, he is only bound to be reasonably cautious and careful. His lordship then referred to the circumstances which led to the auditors being deceived, and came to the conclusion that they were not wanting in skill, care or caution, in accepting the figures of the manager, and he concluded as follows: The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. I should be sorry to see the liability of auditors extended any further than in *In re The London and General Bank*. Indeed, I only assented to that decision on account of the inconsistency of the statement made to the directors with the balance sheet certified by the auditors and presented to the shareholders. This satisfied my mind that the auditors deliberately concealed that from the shareholders which they had communicated to the directors. It would be difficult to say this was not a breach of duty. Auditors must not be made liable for not tracking out ingenious and carefully-laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable.

KAY, L.J., concurred.

THE WESTERN COUNTIES STEAM BAKERIES AND
MILLING CO. LTD.*

(Decided by LINDLEY, SMITH AND RIGBY, L.JJ., in the Court of Appeal, on 11th March, 1897)

Held that an accountant who certifies the accounts of a company as auditor, but who has never been properly appointed as auditor, is not an officer of that company.

This was an appeal from a decision of Mr. Justice Stirling. The appellants, Messrs. Parsons & Robjert, had been employed by the directors to prepare a balance sheet and audit accounts of the above company for the year 1889; one of their clerks did the actual work, and signed the name of the firm at the foot of the accounts, vouching for their accuracy. The liquidator, in the winding-up, sought to make the two partners in the firm liable in respect of dividends declared on the faith of these accounts, by summary process, under the misfeasances clause (Section 10) of the Companies Act, 1890.† Mr. Justice Stirling held that Messrs. Parsons & Robjert was an 'officer' of the company within the meaning of that section, and was liable. Mr. Parsons appealed.

Their lordships allowed the appeal with costs.

JUDGMENT

LINDLEY, L.J., read the following judgment: The question raised by this appeal is whether Messrs. Parsons & Robjert are liable to be proceeded against under that section as an 'officer' of the company. To answer this question it is necessary to ascertain who Messrs. Parsons & Robjert are, and what they have done. They were accountants employed by one of the directors to audit the accounts of the company and to prepare a balance sheet for the year 1889, to be laid before the shareholders of the company at their annual general meeting. This they did; he and his partner signed, *per pro.*, a certificate at the bottom, worded,

* [1897] 1 Ch. 617; *The Times*, 12th March, 1897.

† Now replaced by Section 333 of the Companies Act, 1948.

'We have carefully examined the accounts of the Western Counties Steam Bakeries and Milling Company, and find the same to be in accordance with the above balance sheet, which shows the correct financial position of the company'. The accounts were, in fact, examined, and the balance sheet prepared by a clerk of the firm, and he signed the name of the firm at the bottom of the certificate; but no reliance was placed by the appellants upon this circumstance. They admitted their clerk's authority to act for them, and they admitted their own liability for what their clerk did. Messrs. Parsons & Robjert were paid £12 12s. for their services by a cheque of the company. Now, if Section 10 of the Winding-up Act, 1890, contained the word 'auditor', it might well be that Messrs. Parsons & Robjert, having acted as they did, could not be heard to say that they were not auditors, and Section 10 might well apply to them. But the word 'auditor' is not in the section, and what has to be determined is whether Messrs. Parsons & Robjert are officers of the company, or have so acted that they cannot be heard to say that they were not. If all persons who did auditor's work for a company were officers of the company the case would be easy; but no decision has yet gone this length. An auditor may or may not be an officer of a company. So may anybody else—e.g. a banker or solicitor. *Prima facie* such persons are not officers. To be an officer there must be an office, and an office imports a recognised position with rights and duties annexed to it; and it would be an abuse of words to call a person an officer who fills no position either *de jure* or *de facto*, but who happens to do some of the work which he would have to do if he were an officer in the proper sense of the word. Messrs. Parsons & Robjert performed the duties which an auditor would have had to perform; it appears to me that they were no more *de facto* than *de jure* an officer of the company. They were simply accountants, called in by the directors to do a piece of work, and they never were and never pretended to be, or acted as if they were, anything else. In my opinion the decisions in the cases of *The London and General Bank* and *The Kingston Cotton Mills Co.* decided two points only: viz., first, that auditors might be officers within Section 10, a proposition which, in the first case, was very stoutly disputed; and, secondly, that the auditors in those cases were officers of the companies then in question; that is, that the persons there had within Section 10 really filled the office of auditor in those cases respectively.

SMITH, L.J.: If the appellants were officers of the company upon 30th January, 1890, when they certified the correctness of the company's balance sheet for the year 1889, they may be proceeded against by means of such summons, otherwise they cannot be. It has been held by this Court in the case of *In re Kingston Cotton Mills Co.* ([1896] 1 Ch.D. 6), following the case also in this Court of *In re London and General Bank* ([1895] 2 Ch.D. 166), that where a company having articles of association similar to those in the present case has appointed a person to the office of auditor of the company, such person is an 'officer' within the meaning of Section 10 of the Companies (Winding-up) Act of 1890. It having thus been held that a person appointed by the company to the office of auditor of the company is an officer within the meaning of the section, we are now asked to take a step further and to hold that a person who has never been appointed to the office of auditor or to any other office in the company at all is nevertheless an officer of the company if he has performed work which an auditor if he had been appointed by the company to the office of auditor would have undertaken and performed. The first case which is relied upon is that of *Gibson v. Barton* (L.R. 10 Q.B. 329), where it was held that a man who performed the work of a manager of a company became thereby the *de facto* manager. The learned judges held that 'manager' in the 1862 act meant manager *de facto*, and that a person who performed manager's work becomes thereby manager; but how does this establish that a person who performs auditor's work becomes an officer of the company? I agree that performing the work of an auditor shows the person to be a *de facto* though he may not be a *de jure* auditor, but to succeed, the liquidator must show that the person is a *de facto* 'officer'. Some auditors are officers of a company and some are not. Those who are officers are within the section, not those who are not officers. It is no good showing that a person performs auditor's work; it must be shown that he is a *de facto* officer of the company. The next case is *Coventry and Dixon's case* (14 Ch.D. 660). There two directors did the work of directors without being qualified to be directors. Sir George Jessel held them to be *de facto* directors though

they were not *de jure* directors, and as such were liable to be proceeded against summarily by way of a misfeasance summons. When this case was under appeal (it was reversed upon another point) Lord Justice Bramwell said if he (that is the director) has done anything wrong as a *de facto* director no doubt he can be got at under the clause. In this I agree, and if Messrs. Parsons & Robjert had done anything wrong as *de facto* officers they could be got at; but they have done nothing of the sort, for the simple reason they have never become officers of the company at all. I agree that doing the work of a director may make a person a *de facto* director, and the section enacts that a director may be proceeded against by summons. Doing the work of a manager may make a person a *de facto* manager, and the section enacts that a manager may be proceeded against by summons. So in the case of a liquidator. Doing the work of an auditor may make a person a *de facto* auditor, but the section does not make an auditor liable to be proceeded against; it is only when he is *de facto* or *de jure* an officer of the company that he can be proceeded against by summons under Section 10. In this case Messrs. Parsons & Robjert were neither *de facto* nor *de jure* officers of the company; then how can they be said with truth to be officers of the company? All that this Court has heretofore held is that an auditor may be proceeded against by summons if he is *de facto* an officer of the company. It has not held that a man may be proceeded against by summons when he is neither *de facto* nor *de jure* an officer of the company. The question is not, were the applicants *de facto* auditors? It is, were they *de facto* officers?

RIGBY, L.J., concurred.

WILDE AND OTHERS v. CAPE & DALGLEISH*

(Decided before LORD RUSSELL OF KILLOWEN, C.J., and a special jury, in the Queen's Bench Division, on 27th May, 1897)

Held that an auditor is liable for losses occasioned by his not fulfilling his contract.

In this action the plaintiffs, Messrs. Wilde, Burchell & Burchell, a firm of solicitors, claimed damages from the defendant, Mr. Dalgleish, who carries on business as an accountant at 8 Old Jewry, E.C., under the name of Cape & Dalgleish, for negligence and breach of duty in auditing the plaintiffs' books and in preparing and certifying their balance sheets.

It appeared that the defendant had been employed to audit the plaintiffs' books for the years ending 30th September, 1890 to 1895, and to examine and certify balance sheets for each of those years. The negligence complained of was that the defendant did not carefully examine the plaintiffs' pass books and omitted to discover certain fraudulent entries made in them. By these fraudulent entries the plaintiffs' cashier had defrauded them of £1,756 4s. 9d., which sum they now claimed from the defendant. The defendant's case was that all he was bound to do under the terms of his employment was to see that the plaintiffs' books were brought to a correct balance and to raise a balance sheet and profit and loss account as between the partners, taking the entries and balances appearing in the books as correct. He denied that he was employed to make a cash audit, or check receipts or payments, or examine the cash book or bank book in any way, or to be in any way responsible for the accuracy of the cash transactions. These, the defendant contended, were the conditions of employment arranged with Mr. Cape, the defendant's deceased partner, by the plaintiffs in 1883. In 1884 Mr. Dalgleish entered into partnership with Mr. Cape, who died in 1889, and since that date he had audited the plaintiffs' books with the object above stated—i.e. to ascertain the profit and loss account as between the partners, accepting the accuracy of the entries appearing in the books. He repudiated all responsibility for not having discovered the defalcations of the plaintiffs' cashier.

After evidence had been given by the plaintiffs, during the midday adjournment the parties came to terms.

Mr. Bigham said that his client was unaware of the terms which had been arranged between the plaintiffs and Mr. Cape, and did not know that he was to check the accounts in the pass book. After hearing the plaintiffs' evidence as to the arrangements made with Mr. Cape, Mr. Dalgleish thought that, with regard to

* *The Times*, 28th May, 1897.

the loss caused by the defalcations of the cashier, he ought to meet the plaintiffs half-way, and was prepared to consent to judgment for them for £850.

JUDGMENT

THE LORD CHIEF JUSTICE gave judgment for the plaintiffs for this amount, and added that it was only fair to Mr. Dalgleish to say that the settlement of the case must not be taken as any reflection on his personal skill or care. The difficulty had arisen solely owing to a misunderstanding on his part as to the terms of his employment by the plaintiffs.

MARTIN v. ISITT*

(Decided before LORD RUSSELL OF KILLOWEN, C.J., and a Special Jury, in the Queen's Bench Division, on 3rd and 4th March, 1898)

Monthly audit—Action against auditors for alleged negligence—Defence that the proper materials were not supplied to do the work—Judgment by consent.

This was an action brought by Messrs. James Martin & Sons, milk and grain merchants, against Messrs. Isitt & Co., chartered accountants, for negligence in not checking the cash book and the bank pass book, whereby a clerk was enabled undiscovered to embezzle £612 19s. 2d., the property of the plaintiffs. The defendants alleged that they were unable to properly proceed with their agreed work owing to the neglect of the plaintiffs to give proper facilities, and in particular they complained that the books were not properly posted up and were full of errors, of which the defendants were unable to get the necessary explanations.

It appeared that in 1887 Mr. Eldrid, now a member of the defendants' firm, agreed with plaintiffs to do certain work which was not material to the present action, and also undertook the 'monthly checking of all your books' for an inclusive fee of thirty guineas, afterwards increased to sixty guineas. It was not the defendants' duty to audit, but merely to 'check' the books. To enable this to be done clerks were sent down to the plaintiffs' head office at Brockley, and they spent there a very considerable number of hours doing the requisite work. The books were written up and posted by the plaintiffs themselves; with this the defendants had nothing to do. It further appeared that a man named May, in charge of a branch of the plaintiffs' business, received money, and in a weekly statement sent to the plaintiffs credited himself with payments into a bank, which payments should in ordinary course appear in the London and County Bank pass book of the plaintiffs. In fact, from the last week of November, 1896, until the end of March, 1897, he habitually embezzled the money. The plaintiffs would enter in their cash book the amount alleged by May to have been paid into the bank; the pass book, of course, would not agree with the cash book, and the plaintiffs complained that this was not discovered until the first days of April, 1897. It was admitted that the discovery was made by, and was due to the work of, the defendants; but it was then alleged against the defendants that the discovery should have been made earlier. The reply of the defendants to this was that the state of the books was such, and the queried items—the explanations of which were constantly delayed—were so numerous, that they were unable to proceed fast enough to keep pace; and that, in December, 1896, they were still engaged in dealing with the entries relating to the summer months of 1896. Further, they said that they were requested by the plaintiffs not to proceed with the work in January and that the month of February was wasted owing to the default of the plaintiffs. The senior member of the plaintiffs' firm was called, and gave evidence supporting his own and negating the defendants' case, but his cross-examination was not concluded when the Court rose for the day.

Before resuming the hearing the next morning a consultation took place between counsel, and as a result, Mr. Carson stated that he understood that it would not now be contended that the defendants had been negligent or unskilful in the way in which they had done their work, but that the plaintiffs would rest their case on a breach of one term of the contract—viz. the agreement to attend monthly. That being so, and recognising that the plaintiffs had suffered a loss, the defendants were quite willing to share that loss, to a certain extent, and consequently terms had been arranged.

* *The Accountant* L.R. (1898) 41.

THE LORD CHIEF JUSTICE said that as he understood the case as placed before him, no allegation of negligence or unskilfulness was now made, but that it was urged that the defendants should have attended somewhat earlier than they actually did; that was a question to be tried, but he thought the action of the parties in arranging the matter to be very proper.

COX v. EDINBURGH AND DISTRICT TRAMWAYS CO. LTD.*

(Decided by LORD KYLLACHY, in the Scottish Outer House of the Court of Session, on 16th June, 1898)

Held that when a tramway company alters its system from horse traction to cable traction nothing need be written off capital account before paying dividends out of current profits.

LORD KYLLACHY gave judgment in the suspension and interdict at the instance of Robert Cox of Gorgie, M.P., residing at 34 Drumsheugh Gardens, Edinburgh, against the Edinburgh and District Tramways Co. Ltd., 1 South Charlotte Street, Edinburgh. The complainer seeks to have the respondents interdicted from declaring or paying any dividend on any shares of the company out of the capital of the company; from paying any dividend except out of the net profits of the whole business of the company; and from declaring any dividend until due provision has been made out of the net revenue for loss of capital or depreciation of assets on capital account; and, in particular, until the sum of £20,000 or other loss arising on the realisation of the existing stock of horses, cars and plant has been provided for.

LORD KYLLACHY said: This is an action brought by a shareholder of the Edinburgh Tramways Co. by which he seeks to restrain the respondents from paying a certain dividend for the first half of the current year 1898; or at least from paying that dividend until provision is made for a certain loss, which, it is stated, has arisen, or is about to arise, upon the realisation of the existing stock of horses and cars belonging to the company. The respondents dispute the relevancy of the complainer's statement, and the parties (without renouncing probation) are agreed in asking a judgment on relevancy. They are also agreed that for that purpose a certain minute of admissions shall be taken as forming part of the complainer's statement. The facts upon which the complaint is rested are, shortly, these. The respondents—a limited company—hold (in substance) a lease for a term of years of the Edinburgh tramways. They pay a rent to the corporation for the heritable subjects, and their business consists in working the tramways, for which purposes they provide the necessary rolling stock, including a number of cars and horses. It has lately been arranged that, in consideration of an increased rent, the corporation shall convert the tramway lines into what is known as cable tramways, and the existing stabling into a station or stations, for the fixed machinery required for working the cables. This conversion it is said, although not yet completed, will be so in the course of the present year; and, of course, the result will be to supersede the use of horses for haulage, and also, to a large extent, to supersede the existing cars by cars of a different construction. What the complainer alleges is that, upon the sale which must follow of the horses and cars at present in use, there will be a loss to the company of over £20,000—that is to say, a difference of that amount between the prices realised and the cost or value of the horses and cars as at present standing in the company's books. He also alleges that the cost to the company of providing new cars and 'grippers' will be about £45,000, and that in addition there will be the cost of cables for the entire system. He does not allege or suggest that the conversion in progress is not and will not be beneficial to the company, or that the directors of the company have not fully considered its effect on their financial position, or that anything has been, or is being, done which will leave the company with assets insufficient to pay its debts. His case simply is that the transaction involves an element of a certain sacrifice of existing assets. That is, as I read it, and as I think it must be read, the meaning and substance of his averments, and in particular his statement that 'It is believed and averred that there will be a loss or depreciation upon the

* *Glasgow Herald*, 17th June, 1898.

assets of the company in respect of such realisation, amounting to not less than £20,000'. I do not go into the question as to the additional alleged loss on temporary stabling; or as to the sufficiency or insufficiency of certain sums paid out of revenue into suspense accounts, to meet that and other alleged losses. For the purposes of the argument it seems enough to take the alleged prospective loss in the realisation of the horses and cars. That is sufficient to raise the complainer's case. For I must at least at this stage assume, what the complainer states, that the sum at the credit of the suspense account is quite inadequate to meet the alleged loss or deficiency on the horses and cars. Now I have had a full and very able and interesting argument on a general question which has of late years occupied, it is said, the attention of the English Courts—the question, namely, whether and how far loss or depreciation of assets forming the capital stock of a limited company bars the payment of dividend until that loss or depreciation has been recouped. It was, on the one hand, contended that the principles as applied and expounded by the English Court of Appeal in the cases of *Lee v. Newchattel Asphalt Co.* (41 Ch.D. p. 1) and *Verner v. General Investment Co.* (2 Ch. [1894] p. 239) are conclusive against the complainer—establishing, as it is said these cases do, that with respect to fixed or permanent, as distinguished from circulating or floating capital, there is no rule of law by which such capital must be maintained at its original or any particular value; but that, on the contrary, so long as there is a surplus, sufficient for dividend, of annual revenue over annual outgoings—that is to say, a surplus arising on a revenue account properly kept—the state of the company's capital account is, as affecting dividend, a matter of no moment. On the other hand, it was argued for the complainer that the decisions referred to have not yet been considered by the House of Lords; that they are contrary to previous decisions, and are not well-founded in principle. It was further argued that, even assuming the law to be as there held with respect to fixed capital or assets, the horses and cars here in question are not property assets of that character. They are, it is said, subject to continuous waste, and to waste requiring to be replaced, and that such waste (or, rather, the cost of its replacement), however large and however caused, must always and necessarily form a charge against revenue. Now, I may not perhaps be bound by these English decisions, although, of course, they are decisions of high authority; but I may say at once that I have no difficulty in accepting not only their results but their general doctrine. At the same time, I do not myself see that the respondents in this case require to appeal to those decisions or to the principles new or old there expounded. Nor, on the other hand, am I quite clear that if the respondents' defence did require such an appeal, such appeal (I mean as an appeal to those particular authorities) would be entirely conclusive. The view I take of the present case is shortly this. It is not at all, in my opinion, a case such as might have presented itself if, for example (the respondents still working the tramways by horse traction), a fire or other catastrophe had occurred by which, say, their horses perished, and their cars were destroyed. In that case there would, of course, have been beyond question a loss of assets in the most real sense, and a loss beyond doubt requiring to be replaced. And that being so, questions, I think, of some difficulty would or might have occurred as to how far the necessary replacement could properly or justifiably be charged to capital. It does not, however, appear to me that (taking the facts of this case as they appear on the complainer's statement and the minute of admissions) we have here to deal with anything which can be considered as in any real sense a loss or depreciation, actual or prospective, of the respondents' assets. The selling off of their horses and cars is, or will be, a voluntary act on the part of the company. It is part of a scheme or transaction on which the company has embarked, presumably for the benefit and not for the detriment of their undertaking and if such scheme or transaction involves, by reason of enforced sale or otherwise, a sacrifice in one direction, such sacrifice will at least presumably be compensated by a corresponding gain in some other direction. I am, I think, entitled to hold that that is the view of the directors and of the company. I am also, I think, entitled to hold that they entertain that view on reasonable grounds—grounds, at all events, which are not impeached by the complainer. But if that is so, it is surely a strong suggestion that I should assume without inquiry that the company, as a going concern, will suffer upon the total transaction a loss equal to the loss on its discarded assets, or, on the other hand, that I should allow

a proof as to the effect on the company's general assets of the proposed conversion from horse to cable traction. I am certainly not prepared to make such an assumption, nor, on the other hand, am I prepared to allow such a proof except upon averments of a quite different kind from those with which I have here to deal. In saying so I do not proceed on any law or doctrine established or said to be established by recent decisions. I proceed on a principle as old as the beginning of company law—the principle, namely, that in matters of the kind here in question—matters necessarily of estimate and opinion—a company is presumably the best judge of its own affairs. In such matters the Court will not readily interfere with the company's action and it will not do so at all except on averments which involve practically a case of fraud or dishonesty. The truth is that the complainant's argument involved, as it seemed to me, the assumption that capital sunk—that is to say, capital not represented by tangible and available assets—is in all cases to be considered as capital lost. Of course, if that were so, the question or kind of question would here arise which arose in the two English cases of which we have heard so much; but such a proposition has never, so far as I know, been, as yet at least, advanced. The case suggested by Lord Justice Lindley, of expenditure made in starting a newspaper, is a very good illustration of the impracticability of such a doctrine. But, apart from extreme cases, few things are, I should think, more common in ordinary business than operations of the kind with which we are concerned. A merchant or manufacturer desires to enlarge his premises, satisfied that it will pay him to do so. He accordingly pulls down old buildings which have a certain value and he replaces them by others at perhaps great cost. There is thus, of course, in a sense, the sacrifice of a permanent asset, and it may quite well happen that the new buildings if put into the market would not fetch a sum equal to the value of the old building plus the cost of the new. But for the purposes of the trader's business the result may be entirely the other way, and the presumption is that the trader is satisfied that it is so. If he is so satisfied he will certainly not consider that he has sustained a loss of capital, or feel bound to carry the cost of the old building to the debit of his profit and loss account for the year. Similarly, a manufacturer requires or resolves to discard certain machinery and to replace it with other machinery more effective or more economical. Here, again, the sacrifice in the case of the old machinery is simply an item in the cost of the change. So also, when a railway company, as sometimes happens, alters its gauge, or substitutes, say, steel for iron rails. The operation necessarily involves a sacrifice of old material. But the assumption always is that the operation as a whole enhances the value of the concern or undertaking. And although it may be a prudent and proper thing to provide for the recurrence of such expenditure, and to set up a renewal fund, that is a question which the trader considers for himself, and one as to which, even in the case of limited companies, Courts of law are not accustomed to interfere. On the whole matter I am of opinion that the complainant has stated no relevant case for interfering with the proposed dividend, or for granting him interdict in terms of any part of his prayer.

His lordship accordingly refused the note with expenses.

THOMAS v. THE CORPORATION OF DEVONPORT*

(Decided by LORD RUSSELL OF KILLOWEN, C.J., and A. L. SMITH and VAUGHAN WILLIAMS, L.JJ., in the Court of Appeal, on 2nd November, 1889)

Held that an elective auditor cannot claim remuneration out of the borough fund, but is entitled to reasonable remuneration as auditor of urban sanitary authority.

In this case the plaintiff is the elective auditor of the defendant corporation, and is also designated by statute as the auditor of the urban sanitary authority. He claimed remuneration as elective auditor out of the borough fund, and he also claimed remuneration for twenty-three and a half days' work as urban sanitary

* *The Times*, 3rd November, 1889.

auditor during the number of years past at the rate of two guineas a day. Phillimore, J., who tried the action, held that the plaintiff was not entitled to any remuneration as elective auditor, and with regard to his work as the auditor of the urban sanitary authority said the plaintiff was barred by the Statute of Limitations with respect to some of the days claimed for, and he had taken longer than was necessary to do the work in the later period for which he claimed. The learned judge held that £34 paid into Court by the defendants in respect of sixteen days' work during the past two years was sufficient remuneration for the plaintiff's services as auditor of the urban sanitary authority, and therefore gave judgment for the defendant corporation on both issues. Hence the plaintiff's appeal.

JUDGMENT

THE LORD CHIEF JUSTICE, in giving judgment, said this was one of those cases under the statute in which the corporation was also the urban sanitary authority. The case really would have been unarguable on the part of the plaintiff if it had not been for some observations made by Phillimore, J., in delivering judgment. As regarded the claim in respect of auditing the corporation accounts as such it was quite clear that there was not a shadow of ground for saying that the plaintiff as elective auditor had any claim at all. The receipts of the corporation as such were brought into and formed part of the borough fund, and payments of all accounts legally made by the corporation must be paid out of that borough fund. Parliament had in clear and distinct terms laid down the appropriations which might be made out of the borough fund in the statute regulating the matter. If the plaintiff had been a servant of the corporation there was ample power given to the corporation to pay him out of the borough fund in respect of any services which he rendered. But he was not a servant of the corporation. He was elected by the burgesses of the borough under a statute giving the burgesses power to elect an auditor. There was no claim in respect of such services. As regarded his services as auditor of the urban sanitary authority, he was entitled to be compensated at a rate of not less than two guineas for every day on which he was properly employed on the work. If the matter had simply rested there, there would have been an end of it, and it would not have been possible for this Court to have reviewed the judgment of the learned judge of the Court below, because he found as a fact that four days in each half-year—or eight legal days in each year—was ample for the work which the plaintiff did. Unfortunately, as he (the Lord Chief Justice) thought, Phillimore, J., had used some language which suggested too narrow a judgment of what the proper duties of the auditor of the urban sanitary authority were. He (the Lord Chief Justice) did not subscribe to the doctrine that the auditor's sole duty was to see whether there were vouchers, formal and regular, justifying each of the items in respect of which the authority sought to get credit upon the accounts. That was an incomplete and imperfect view of the duties of such an auditor. Such an auditor was not only entitled, but justified and bound, to go further than that. He should make a fair and reasonable examination of the accounts and see whether there might not be, amongst the payments made, payments which were not authorised or which were illegally made, and if he so discovered such payments it would be his duty certainly to make them public, certainly to report them to the authority itself, and certainly to report them to the burgesses, who had created that authority. But granting all that, he (the Lord Chief Justice) saw no reason for believing that eight days would not be adequate in which to do the work and he saw no reason for disturbing the judgment of the Court below.

SMITH and VAUGHAN WILLIAMS, L.JJ., said they entirely concurred, and the appeal was accordingly dismissed with costs.

THE IRISH WOOLLEN CO. LTD. v. TYSON AND OTHERS*

(Decided by the LORD CHANCELLOR and HOLMES and FITZGIBBON, L.JJ., in the Irish Court of Appeal, on the 20th January, 1900)

Held that when the accounts of a company have been falsified, and dividends improperly

* (1900) 27 *The Accountant* L.R. 13.

paid out of capital in consequence, the auditor is liable if the falsifications might have been discovered by the exercise of reasonable care and skill.

On Friday, in the Court of Appeal, judgment was delivered on the appeal by Mr. Edward Kevans, chartered accountant, 22 Dame Street, Dublin (one of the defendants), against the decision given by the Master of the Rolls, reported in 25 *The Accountant Law Reports*, p. 89. The question before the Court was simply whether Mr. Kevans was, or was not, responsible for the non-detection of the frauds.

Lord Justice HOLMES, in delivering his judgment, referred to the career of the company which, he said, was formed in June, 1887, for the purpose of promoting the woollen industry in Ireland, the original capital being £6,000. For some time at the commencement the business was almost entirely confined to the purchase of woollen goods from Irish manufacturers. In the year 1889 the directors resolved to develop their undertaking by seeking to establish their home trade, and for this purpose they increased their capital. The prospectus announcing this resolution alluded to the success that had attended the operations of the company up to that time, and held out more brilliant prospects for the future. The whole of the additional capital, however, was required to pay off debts previously incurred, and could hardly be used for the purpose of opening up new business. Between the years 1888 to 1895 nine balance sheets were presented to the shareholders, each showing considerable net profit; and during all this period dividends were paid which never once fell as low as 5 per cent., amounting to £4,649. There is not the slightest evidence of the soundness of the financial position of the company until its operations were suspended, when Mr. Carnegie—the auditor's representative, who was examining the accounts—noticed a double entry. The mistake was a trifling one, and he was satisfied with the explanation given by Mr. Crawford, who had been for some time the accountant of the company. Crawford and Johnson abandoned their positions, and the balance sheet for the last period (1895) showed a deficiency of £11,107. The company, by order of the Court, was directed to be wound up compulsorily, and Mr. Garde—who was himself formerly in the employment of the defendant auditor—found that, although the company was just solvent as regards its creditors, its capital had entirely disappeared, and I presume it was his report that led to the bringing of the present action. It appears that Crawford, acting either by himself or with Johnston, the warehouseman, was a defaulter to a very large extent. Mr. Kevans says, in his letters of the 22nd and 24th January, 1896, 'that although the whole of the items that made up Crawford's deficiency were apparently received within the three months ending 31st December, 1895, it is highly improbable that he could have abstracted all that money in so short a period of time, but that it was impossible to say how far back exactly the defalcations extended'. The defendant was held guilty in connection with Crawford's fraud, and I therefore pass away from this portion of the case, which relates to only a small part of the losses sustained by the company. To account for the rest it is necessary to go more fully into the way the business was carried on. The directors, who were paid no fees for the first two or three years, were originally selected by lot; and Mr. Peter White was appointed managing director; Mr. Tyson was appointed secretary at £250 per annum; and the rest of the staff—examiner and packer—at £150 and £75 per annum respectively. Mr. Tyson did not long remain secretary, and was succeeded by Mr. McDonough, and subsequently by Crawford. Mr. White, in one of his letters, referred in a somewhat gloomy manner to the large annual amount of money paid to the officers in the shape of salaries, and recommended such a change being made as would reduce the annual expenses to £600. White's recommendation was accepted, and from that date Crawford was appointed secretary. He only received 35s. per week, and his income from the company never seemed to come up to £150 a year. I presume that Johnston did not receive more. Mr. Kevans was the first auditor of the company, and he provided the books which, in his judgment, were necessary for keeping the accounts. They consisted of: (1) cash book; (2) customers' ledger; (3) creditors' ledger; (4) day book; (5) invoice guard book; (6) petty cash book. It cannot be denied that these were sufficient to show the true financial position of the business of the company, if they had been honestly kept. Mr. MacDermot commented upon the absence of one book, but I attach no importance to this. The multiplication of books, if written up by different

parties, may be a check upon fraud, but in this case all the book-keeping was done by a single officer who, if dishonest, would take care to make the books appear perfectly straight. There was another book, referred to in the evidence, kept for the private use of the directors, but whatever its significance may be it could not affect Mr. Kevans. In February, 1891, there occurred a circumstance materially bearing upon the case. After that time the auditors fee was increased to £40, the consideration being a 'monthly audit'. It was not understood by this that a balance sheet or profit and loss account was to be prepared for each month, or that a monthly statement was to be submitted to the directors. It was a monthly investigation for the purpose of checking fraud or error. It was, as Mr. Kevans himself says, 'a system of monthly checking with a view to the half-yearly audit'. Mr. Kevans seems to have done little of the actual work himself, and the evidence varies as to the nature of the supervision which he gave to it; the investigation of the books he deputed to his assistants—namely Mr. Roche, Mr. Garde and Mr. Carnegie, and it must be on the faith of their representations that he certified the balance sheets. I presume this course is not unusual, and that an accountant with a large business is not supposed to do everything himself. The auditor is bound to give reasonable care and skill but this can also be exercised by his deputy. I do not think there is anything to be gained by considering in the abstract the duties of an auditor of a joint stock company. He is entitled to see the company's books and the materials for their books, and also to ask for explanations. But he is not called on to seek for knowledge outside the company, or to communicate with customers or creditors. He is not an insurer against fraud or error; and if fraud is alleged it must be shown with precision the acts of negligence for which he is said to be responsible. Nine balance sheets were prepared, and the figures on some represent the aggregate amount of many items, but I propose to deal only with matters that have been referred to during the hearing. There are three sets of figures with which I will deal: (1) stock-in-trade; (2) sundry debtors; (3) sundry creditors on the liability side of the balance sheet. Taking these in order, I find that Mr. Garde, in his evidence, drew a distinction between the home stock and the stock in America, which was never mentioned in this Court. I do not fully understand this, as Mr. Kevans can only be held responsible from the 4th January, 1892, and at that date the American trade had been abandoned. The Master of the Rolls expressed a doubt, with which I agree, as to whether it was the duty of the directors to take stock with their own hands. It was taken by Mr. O'Callaghan, and I agree with the Master of the Rolls that he (Mr. O'Callaghan) did quite as much as he could be expected to do. **There was certainly no duty cast on the auditor to take stock.** What he did was to have the calculations checked in his office, and this was done with proper care. Mr. Kevans said he was particularly careful as to the deduction for discount, and, as far as I could gather, the universal rate of 10 per cent. seems reasonable. **Moreover, an auditor has nothing to do with the terms upon which the company or a trader buys or sells.** As to No. 2, the charge in this is that the allowance made for the trade discount of $2\frac{1}{2}$ per cent. was omitted. This is a purely technical question. Mr. Kevans says that the proper method of dealing with these debts was to return them as they stood in the books, and to bring the discount, when it was allowed, to the profit and loss account. Mr. Pixley said it would not be scientifically correct to deduct these discounts. This seems to be in accordance with common sense, and it is to be noted that although Mr. Garde, as liquidator, corrected the balance sheets by marking off these discounts, he never thought of doing so when conducting the audit. **As to the provision for the 'bad debts', if there is any one thing upon which an auditor is dependent upon the officers it is the writing-off or the making of a prospective allowance for bad debts. He has no personal knowledge of the customers,** and Mr. Kevans seems to have taken particular attention in reference to this. (See questions 2,125 to 2,127 in the evidence.) He said 'he had some special knowledge on the subject, that he saw all ascertained bad debts duly written off, and that there was a fund amounting to £500 as a provision therefor'. For the foregoing reasons there is no ground for alleging negligence against Mr. Kevans on the 'assets side' of the balance sheet. As far as this portion is concerned, I think

the balance sheets were properly and carefully prepared, and there was nothing dishonest or negligent on the part of anyone; but if there was, it was not on the part of Mr. Kevans or of his representative. Now dealing with 'sundry creditors'; here evidently there is a fraud, and a curious thing is that no one seemed to have derived any benefit from the fraud. Dealing with the invoices, the learned judge detailed the practice in connection with the statements of accounts being laid before the meeting, and said the ledger was used for the purchases made and for the payments on account thereof. If, then, all this were rightly done it would be easy for the auditor to ascertain the amounts due to the creditors, but unfortunately the books were not properly kept. The creditors' accounts in the ledger did not show all the goods purchased up to the time of the audit, nor could the auditor discover the omissions on account of many of the invoices being either 'suppressed' or not put into the book until a later date—a process described as 'carrying over'. There is some doubt as to whether the deficiency arose from the suppression or the carrying over, but my impression is that the whole of it comes within the last mentioned class, for at the end of 1894 we find they amounted to £4,095. Mr. Peter White is now dead, and he should not be condemned unheard, but it is difficult to believe that this system was not within his own knowledge. As chief promoter he was no doubt anxious to see that the company was successful; Crawford, who was the secretary, appears to have continued the process. It seems strange that a system of fraud so long continued, and for so extensive a period, was never detected by the auditor. Once or twice he noticed something, and the explanation that was given was 'that the goods were not taken into stock'. The question is, was it negligent not to have seen this? **There is no doubt that both the suppression and carrying over of invoices would have been detected if the auditor had called for the creditors' statements of accounts upon which payment was ordered, and compared them with the ledger. I should have thought this was part of the auditor's duty for many reasons;** but all the accountants examined, except Mr. Southworth, stated that this course is never taken unless there is something to arouse suspicion. Mr. Pixley, the eminent London accountant, says it could not well be done except in the case of a very small concern. In the face of such evidence I should not leave myself at liberty to hold that Mr. Kevan's assistants were guilty of negligence in not looking at these statements of account if they were engaged in an ordinary audit. Little time is allowed for doing so; but in this case there was this system of monthly checking. From the time that Crawford was accountant in 1890 the accounts of the company were completely in his hands. Now White, for the two years following, may have given general directions, but he was often away in America for months at a time, and it is clear that the monthly audit was instituted for the purpose of seeing that he (Crawford) would do his work regularly and honestly. I am unable to conceive how, if there was nothing wrong about this monthly checking it did not lead at an early period to the detection of the frauds in this ledger. Mr. Kevans ought to have found out, by the accounts, the payments that were made—and no better means could be adopted than that of a comparison with the statements of accounts. It ought to have been done in some way, and, if it had, detection would have been certain. I do not base my decision on this alone; apart altogether from the statements of account and the monthly check, **I do not understand how the carrying over of the invoices could have escaped detection by the accountant, who should have used due care and skill and who was not a mere machine. The invoices carried over were ultimately posted to the ledger. If they were posted to their true dates it would be at once apparent that they were not entered in at the proper time. If they were posted under false dates, why was this not detected when the ledger accounts were checked with the invoices? and when no invoices came into the books, it is admitted that this ought to have excited suspicion. For these reasons I am of opinion that if due care and skill had been exercised, the carrying over and the suppression of invoices would have been discovered, and the auditor is liable for any damage the company has sustained from the understatement of liabilities in the balance sheet due to this cause since 4th January, 1892. I consider that not only are Mr. Kevans and his assistants not free from blame for this, but also for the mechanical way the audit was carried out. I desire to say that, although**

also a ruling on the 31st December, 1893—there is on the face of the book, as it stands, an undoubted ruling as of the 31st December, 1893. But what is the case? It is conceded that in striking a trial balance for the purpose of statements of account for the year 1893, three items that only appear on the right side of page 150 were in the book at the time. In the book now, before we come to the ruling, there were inserted below these and after them half a column of items totting to no less than £698 19s. 11d., and the whole of that is included in the amount of these 'kept-back invoices' for the year 1893. Well, I will admit that it is not the business of an auditor, when he comes to strike his trial balance, on the 31st December for the purpose of a meeting, to have every account closed and balanced, but he must strike a trial balance, and he did so; but at a figure, 15th December. I do not agree with the monthly check that was taken. Some of these items now introduced must have been there, and therefore within a month of the 31st December, 1893, if the monthly check had been carried out, the representative of Mr. Kevans would have found that after the figure which he had taken for ascertaining the financial position of this company, a string of figures had been put in, all in December, and all within a day or two of the 15th, the day at which the financial position of the company had been ascertained. I think that was something; but it is nothing to what follows, because between that time and whatever time this book was ruled there then follows a further string of items—nearly £600 in amount—that go up to the 3rd November and go down as far as the 14th December. I cannot conceive any more clear or glaring grounds of suspicion than to discover in the account of a single customer items amounting to such a sum having got into the books after the trial balance is struck under dates going back two months prior to the period of the ascertaining of the trial balance. There appears to be a further thing—a monthly check was to be adopted, and that would have put an auditor on inquiry. **It appears to me that the moment I come to the conclusion that that was on the face of it a suspicious mode of dealing with Hill & Sons' figures, I am bound to show how it would be corrected. I can add nothing to the judgment of Lord Justice Holmes—viz. that it would then have been necessary to call for the creditors' statements of account, and at that moment they would have disclosed on the face of them not merely those post-dated items, but the suppressed invoices also; and at the instant that this discovery was made there is an absolute conviction of something wrong forced upon the mind of the auditor.** It, therefore, occurs to me that, upon those two branches, all that is required, both to show the negligence, to arouse suspicion and to supply the means of putting a stop to the frauds is to be found on the face of the book, and for all I have said I have no foundation except what is upon the face of that book (creditors' ledger). I now take the three English cases, in order to make a few observations on each. In 36 Ch.D., in the *Leeds Estate Building Investment Co.*, Mr. Justice Stirling held that the manager and auditor were liable. It is right to say that the procedure in the other cases was different from this Leeds case; and it is important to bear in mind that the other two were under the 10th Section of the Winding-up Act.* In this case the auditor was held liable, and Mr. Justice Stirling held him liable, saying that it was his duty to see that no part of the capital was applied to any other than the proper purpose, and, in particular, that no part of the capital was returned to the creditors—that is, in dividends—except in the cases in which a reduction of capital was permitted by various Acts of Parliament. The next case, and the most important one, is the *London and General Bank* ([1895] 2 Ch.D. 681). That was a procedure under this 10th Section Mr. Justice Lindley says, 'An auditor has nothing to do with the prudence or imprudence of the way in which the business has been carried on; nothing to say as to whether it was properly, improperly, profitably or unprofitably carried on, provided he discharges his own duties to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that'. But then comes the question, 'How is he to ascertain that?' The answer is by examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking the common trouble to see that the books show the company's true position. He must take reasonable care to see that this is done (page 682), otherwise the audit reduces

* Now Section 333 of the Companies Act, 1948, usually known as the 'misfeasance' Section.—ED.

itself to an 'idle farce'. I have endeavoured to keep myself within that, and think that the principle is the very lowest upon which we can define the duties of an auditor. In the *Kingston Cotton Mills* case (1 Ch.D. 96, 279), Mr. Justice Vaughan Williams held, 'that it was the duty of the auditor to have made a calculation outside the books which, if made, would have shown that the amount of the stock was overstated on the books'. In this case of the stocktaking and the over-valuing, &c., Mr. Kevans is exonerated. Now, time after time, this passage about the 'watch-dog and the bloodhound' has been made use of, and I would wish to say a word regarding it, too. His lordship then read from Lord Justice Lindley's judgment the passages dealing with the duties of auditors, in one of which it was laid down that 'an auditor was a watch-dog, but not a bloodhound'. This, Lord Justice Fitzgibbon remarked, was very unfair to the bloodhound, who was just as little likely to have his sense of suspicion aroused as the watch-dog. Applying this instance of the dogs to the present case, was not the watch-dog bound to bark? and if, when sniffing round, you hit upon a trail of something wrong, surely you must follow it up, and there is just as much obligation on the auditor, who is bound to keep his eyes open, and his nose, too. As in the case of the hound, the auditor will follow up this trail to the end, and the first things he will 'root up' are those statements of account, and then the fraud is discovered. On the question of damages—the damage here—and I guard myself against expressing any individual opinion upon anything more than is necessary—is sufficiently supplied for the purpose of showing the existence of pecuniary losses. In the first place, there has been a paying away of a large amount of money in dividends to the shareholders that had not been earned, and therefore at the time that that was stopped the company ought to have been in possession of a money capital, which they had parted with by paying it away to their shareholders. It would be premature to discuss the pecuniary damage until the financial position of the company is finally ascertained. Then, again, had this system of the suppression—the carrying forward—of invoices been detected sooner, it would have been open to the directors to have done something to stop it. They had several ways, either to increase their percentages or diminish their dealings—in the latter case thereby producing a less loss; or they could have stopped the business and wound it up. On the question of the amount of the damages, that depends on the amount of the losses the plaintiff has suffered, taking all the circumstances of the case into consideration. We have not all these circumstances before us, and it is, I say, premature to discuss damages at all beyond the point I have discussed them. I have come with much reluctance to the conclusion that a professional man has failed in his duty, and I am glad to be able to think that the worst that could be said of the case is this: That, in what is so small a company, Mr. Kevans and his representative, who went there to do this audit (for which Mr. Kevans received a very small fee), were deceived not by any glaring or probable fraud such as they would be on the watch against, but by a thing that was done more for the purpose of giving an appearance of fictitious prosperity to a company which did not exist than that of putting money into the pockets of shareholders. That, however, cannot alter the legal liability if it is based, as I am satisfied it is, upon the failure to have suspicion aroused.

THE LORD CHANCELLOR also concurred, and the appeal was accordingly dismissed.

Re JOSEPH HARGREAVES LTD.*

(Decided by COZENS-HARDY, J., in the Chancery Division, on 15th February, 1900)

Held that an auditor who refuses to certify the accounts of a company cannot be held liable because no correct accounts were submitted to the shareholders

In this case a summons was taken out by the voluntary liquidator of Joseph Hargreaves Ltd., asking the Court to hold three directors and the auditor of the company liable for misfeasance in having declared dividends, amounting to £2,602, out of capital. The directors who were respondents to the summons were Messrs. Pullen, Holloway and Brown; and the auditor was Mr. Theodore Brook Jones, chartered accountant, of Albion Street, Leeds. The company carried on business as spinners at Shipley and Bradford, and the allegation against the

* [1900] 1 Ch. 347; *Leeds Mercury*, 16th February, [1900].

respondents was that in 1894 and the two following years dividends were declared when the company had really made no profit. The company had passed resolutions for voluntary winding-up in August, 1897.

The affidavit of Mr. Jones was read by Mr. Eve. The deponent stated that he had never received any remuneration from the company, and he had not acted as auditor after the 22nd June, 1895. A valuation of the machinery had been made by Mr. Marshall in 1894, and that gentleman had arrived at a figure of £16,119, with an addition of 10 per cent. owing to the marked improvement in the textile trade.

Mr. Jones was cross-examined by Mr. Hughes. He said he saw to the preparation of the memorandum and articles of association, and he gave all the information he could to the shareholders at their first meeting. He knew that certain sums were paid to the shareholders as dividend, but when he found no profit had been made he refused to sign the balance sheet. He several times spoke to Mr. Holloway on the subject, but nothing was done. He denied that he concurred in any resolution that any sum should be carried forward. Witness was not reappointed auditor in December, 1895, but his firm acted as auditor more through friendly feeling towards the directors than anything else. He never received a penny as remuneration, and had never sent in an account, though one of his clerks, contrary to instructions, had sent in an account to the liquidator. He acted as much in the shareholders' interest as in the directors', but he did not report to the company in general meeting. He more than once protested to Mr. Holloway that dividends were paid before the accounts were audited. He could swear positively that there were no balance sheets signed by him or on his behalf. Dividends had been paid to him in respect of the shares he held in the company.

Re-examined: I told the directors that they were liable for the dividends which had been paid out of capital.

Mr. Stewart Smith read the affidavit of Mr. Pullen, to the effect that that gentleman up to the formation of the company had been general manager of Mr. George Hargreaves' mills, Holloway was cashier, and Brown salesman. After the company was formed they continued to work in their own departments. He never had brought to his notice the objections to the accounts which the auditor made to Mr. Holloway. He did not, however, dispute his liability in respect of such dividends as had been paid out of capital. The learned counsel desired to say that Mr. Pullen was the holder of only 250 ordinary shares in the company, on which there had never been any dividend paid, and he had never received a shilling out of the company in which he had sunk all his money.

His lordship asked if the liquidator would be content with an order for the payment of the 1896 dividend only.

Mr. Hughes desired to be moderate, and said he would take an order that the directors were jointly and severally liable in respect of £1,177. As regarded the auditor, he argued that it was a plain case of neglect of duty against him, as he should either have brought the matter to the knowledge of the shareholders or he should have resigned.

JUDGMENT

COZENS-HARDY, J.: In this case I have made up my mind—so far as the directors are concerned I need not say any more as to them. The question remains as between the liquidator on the one hand and the auditor on the other. It is sought to make the auditor liable for three dividends paid out of capital, and it is sought to make him liable under circumstances the like of which, so far as I am aware, have never occurred before. Mr. Jones has never signed any balance sheet; no resolution of the company or of the directors has ever been passed for the payment of a dividend; nothing has ever been done by the directors, or by anybody on the footing of any inaccurate statement, insufficient statement, or dishonest statement, by Mr. Jones. Mr. Jones told the directors that, in his opinion, the payment of the dividend which had been made before the first audit was improper, because that was only justified by reason of an appreciation of the value of the machinery, which appreciation, assuming it to be proper, ought not in Mr. Jones's view to have been carried to the credit of profit and loss, but ought to have been carried to a suspense account, unless and until the shareholders' general meeting otherwise resolved. Mr. Jones for that reason deliberately refused to sign the

balance sheet. No general meeting was called after that. That is the result of the evidence which is before me, and there is not a particle of evidence that any such general meeting ever was called; and Mr. Jones's duties, as defined by the articles of association, are first of all to examine and ascertain the accuracy of the profit and loss account and balance sheet and to report to the company in general meeting upon it. He could not, and would not, certify the correctness of this balance sheet, and I think he was perfectly right in refusing to do so. He did not report upon it to the general meeting for the best possible reason—that there was no general meeting to which he could report; and it is sought really, I think, when one gets to the bottom of the case, to render the auditor liable because he did not require a general meeting of the shareholders to be summoned, to which he could make a statement as to the improper conduct of the directors. Well, how could he have summoned a meeting? He had no more power to summon a meeting than I have. I think, in Table A, five shareholders, I think it is—but never mind what the number is—can call a general meeting. But he could not call a general meeting. He did remonstrate with the directors and suggest that they should call a general meeting, but they did not do so. Now, these dividends in each of the years were paid out of the bank of the company without any resolution of the shareholders in general meeting, without even any resolution of the board of directors at a board meeting, and in each and every year the payments which are said to be, and which for the present purposes are assumed to be, improper were actually made before the audit of the accounts was completed. It would be startling, I think, to say that an auditor who knows that dividends have been improperly paid out of capital is to be rendered liable because he does not commence an action on behalf of himself and all the other shareholders, I suppose, against the directors who have improperly paid these dividends, or does not do that which he really had no power to do—get the general meeting together and inform them of the facts. I think the duties of an auditor are accurately, and, I might almost say exhaustively, defined by Lord Justice Lindley in the *London and General Bank* case: he must be honest; he must not certify what he does not believe to be true; he must take reasonable care and skill before he believes that which he certifies is true. I think Mr. Jones has fully come up to that definition. Certainly, as far as I am concerned, I am not prepared to extend the liabilities and responsibilities of auditors to the enormous extent to which I should be obliged to extend them if I agreed with the present application. I think, therefore, the summons must be dismissed with costs as against Mr. Jones. The order will go with costs against the three directors. For the last year, the 1896 dividend.

Mr. WHEELER: And interest as asked by the summons from the date of payment?

COZENS-HARDY, J.: Yes; that would be a matter of course, I suppose.

Mr. WHEELER: That is asked by the summons.

COZENS-HARDY, J.: Of course, your costs and what you pay will come out of the assets of the company. It was quite a proper case to bring before the Court.

FOSTER v. THE NEW TRINIDAD LAKE ASPHALTE CO. LTD.*

(Decided by BYRNE, J., in the Chancery Division, on 28th November, 1900)

Held that the question of what is profit available for dividend depends upon the result of the whole accounts taken fairly for the year, capital as well as profit and loss, and though dividends may be paid out of earned profits in proper cases, notwithstanding a depreciation of capital, a realised accretion to the estimated value of one item of the capital assets cannot be deemed to be profit divisible among the shareholders without reference to the result of the whole accounts fairly taken.

This application raised an interesting question of company law as to the proper method of dealing with an unexpected appreciation of assets. The facts and the nature of the arguments are sufficiently stated in the judgment.

JUDGMENT

BYRNE, J., said: This is a motion on behalf of debenture-holders and of a shareholder in the defendant company to restrain the application in or towards payment of a dividend of the principal of a certain debt recently paid to the

* [1901] 1 Ch. 208; *The Times*, 29th November, 1900.

defendant company by another company called the New York & Bermudez Co. I treat this as a motion on behalf of a shareholder seeking to restrain an *ultra vires* payment. In the year 1894 an American company (referred to in the affidavits as the old Trinidad Asphalte Co.) acquired the stock and bonds of the New York & Bermudez Co., and also a debt of \$100,000 (due from the latter company, secured by promissory notes). In 1897 the defendant company, which is an English company, purchased the property and assets of the old Trinidad Asphalte Co., including the debt due from the New York & Bermudez Co., and on 31st December, 1899, the New York and Bermudez Co. gave to the defendant company new promissory notes for \$127,000, being the amount of the debt of \$100,000 with accrued interest then due. This \$127,000 has recently been paid off, and the defendant company, through their directors, are proposing, without reference to the other business or assets of the defendant company, to treat the whole of that sum, amounting to £26,258 16s. in English currency, as assets available for dividend, and to distribute the same accordingly. This is the statement in the plaintiff's affidavit, and it is not denied by the defendants, so that, although some discussion took place in argument upon the point, I have not now to consider whether or not the amount in question may properly be brought into the next profit and loss account, but simply whether or not the amount may be divided as profit with regard to the present value of the total capital assets, and whatever the result of the year's trading may be. No question is raised as to so much of the sum as represents interest, the point at issue being as to the amount representing principal of the debt. There is no doubt that the debt formed part of the assets originally purchased by the defendant company, and as such part of its original capital assets, but it is argued that as the debt was not regarded or treated as an asset of any value upon the purchase, and as it has not appeared in the former balance sheet as part of the assets of the company, and as the only entry in relation to it in the books of the company is a journal entry carrying the notes to a profit and loss account, it ought to be regarded as a windfall in the nature of an unexpected profit, and as divisible accordingly amongst the shareholders. I cannot except this view. Although the agreement for sale does not enumerate the debt or notes in question in the schedule which purports, according to its heading, to be a statement of assets and liabilities of the old Trinidad Asphalte Co., that schedule is, as appears by Clause 1 of the agreement, an enumeration of matters and things which the vendor warranted to be included in the property sold, or the equivalent in value thereof. Some of the items mentioned in the schedule may have been over-valued, some under-valued, and no doubt fluctuations in value of the assets have supervened, but the amount of this debt is a distinct item of the property purchased which has since been realised by payment. **It appears to me that the amount in question is prima facie capital, and that I have no evidence which would justify me in saying that it has changed its character because it has turned out to be of greater value than had been expected.** It was urged for the defendants that the amount applied in payment of the debt was money earned by the Bermudez Co. by favour of the defendant company, and represents a profit which would otherwise have been earned by the defendant company, and, furthermore, that such money might have been applied by the Bermudez Co. in payment of a dividend on the shares in that company, in which case the defendant company, as owning 9,842 shares out of a total of 10,000 in that company, would have received the greater portion as income. I am unable to follow this argument as I do not see how for the purposes of the present motion I can have regard to the fact that some other course of dealing by the debtor company would have left the debt still outstanding and would have produced more income for the defendant company. I think that I ought to grant an injunction until judgment or further order to restrain the defendants from distributing the \$100,000 as dividend without reference to the other business or assets of the defendant company. **I must not, however, be understood as determining that this sum or a portion of it may not properly be brought into profit and loss account or be taken into account in ascertaining the amount available for dividend. That appears to me to depend upon the result of the whole account for the year. It is clear, I think, that an appreciation in total value of capital assets, if duly realised by sale or getting in of some portion of such assets, may in a proper case be treated as available for purposes of dividend. This,**

I think, is involved in the decision in the case of *Lubbock v. British Bank of South America* ([1892] 2 Ch. 198), cited with approval by Lord Lindley in *Verner v. General and Commercial Investment Trust* ([1894] 2 Ch. 239, at page 265), where he says: 'Moreover, when it is said, and said truly, that dividends are not to be paid out of capital the word "capital" means the money subscribed pursuant to the memorandum of association, or what is represented by that money. Accretions to that capital may be realised and turned into money, which may be divided amongst the shareholders, as was decided in *Lubbock v. British Bank of South America*.' **If I rightly appreciate the true effect of the decisions the question of what is profit available for dividend depends upon the result of the whole accounts fairly taken for the year, capital as well as profit and loss, and although dividends may be paid out of earned profits in proper cases, although there has been a depreciation of capital I do not think that a realised accretion to the estimated value of one item of the capital assets can be deemed to be profit divisible amongst the shareholders without reference to the result of the whole accounts fairly taken.**

HERBERT ALFRED BURLEIGH v. INGRAM CLARK LTD.*

(Decided by JOYCE, J., in the Chancery Division, on 2nd April, 1901)

Held that an accountant has a lien on certain account books for professional charges

Mr. Lawrence said he had a motion in the case of Herbert Alfred Burleigh, of Park Row, Bristol v. Ingram Clark Ltd., booksellers and stationers, of Bristol, against the auditor of the defendant company for an order upon him to hand over the account books of the company to the receiver appointed in a debenture-holders' action. The motion raised a very nice point, and one as to which, as far as he knew, there was no authority whatever—namely, whether the auditor of a company had a lien on the books of the company for his fees. The receiver (Mr. Frederick Jenkins, F.C.A.) was appointed on the 8th February last in the action by Mr. Burleigh on behalf of himself and other first debenture-holders for £7,000, and Mr. W. Grimes, A.C.A., the auditor, was requested to go into the accounts. He now took the view that he had a lien on the books of the company for work done, and he refused to deliver up the books except on payment by the receiver of his account, £137. The way in which he got possession of the books was this. He asked leave of the directors and the secretary to take away the books to his own office, as he said the company's office was small and inconvenient for him, and he could do the work better in his own office.

Mr. Christopher James, for the accountant, said if the money was brought into Court he would hand over the books at once.

Mr. Lawrence said that was just what he contended the auditor was not entitled to.

Mr. James pointed out that Mr. Grimes had done accountant's work to the books, as well as auditor's work.

Mr. Lawrence admitted that some work had been done on the books, as distinguished from work done in respect of the books, and there might be a distinction. He did not think his lordship at present had got the materials for saying how much was actually done on the books, and how much done in the books. He contended that the auditor had no lien for any part of the work. If he had, then there must be some inquiry. He thought if there was such a thing as an auditor's lien on the books he worked upon, it must have been tried on before, but he could not find any record.

JOYCE, J., said he had no evidence here as to the terms upon which the auditor was employed. There might be some resolution of the board, and it was very material to know on what terms he was employed. He might have been employed as accountant as well as auditor.

Mr. James said there was the evidence of Mr. Grimes himself that he was asked by the board of directors to do this accountant's work.

Mr. Lawrence contended that the company, by allowing the auditor to take away the books for his own convenience, conferred on him no right to retain them.

* *The Accountant* L.R. [1901] 65.

He was appointed auditor in the usual way, yearly. He admitted Mr. Grimes had bought a shareholders' register, an important book, for the company, and that the receiver had not yet paid him the price, 31s., but the receiver would see that that was paid.

Mr. James, in opposing the application, said it might be that work done as an accountant and work done as an auditor stood on different footings, but he contended, in any event, the auditor had a lien. The bulk of the work was done as an accountant, and so far as that branch of the work went he clearly had a lien on the authorities. The right of an auditor was no doubt, somewhat different, but even in that case he submitted there was a lien.

JOYCE, J., said, apart from other matters, it was clear the auditor had no right to keep the shareholders' register, as that was a book which the company must keep for public inspection, and he must therefore give it up. That was not an account book. As to the articles of association, he could not see that the article relating to the auditor gave him any lien whatever on the books. At present he was of opinion that no book of the company ought to leave the company's office.

Mr. James said if these books had to be re-bound the binder would have a lien on them for his work.

JOYCE, J., said he did not know, but he thought if a parish register had to be re-bound it could not be retained.

JOYCE, J., asked Mr. Lawrence whether, if the auditor would return the books at once, the receiver would be willing to give the auditor a personal undertaking to pay whatever it might be found he was entitled to. Of course, he did not say that the auditor was entitled to a lien.

Mr. Lawrence consulted his clients, and said they were willing to give that undertaking.

JOYCE, J., said: Very well! This was obviously an urgent matter, because the company must have its books, and this arrangement would settle the matter temporarily. If the books were handed over and the undertaking given, he would postpone his decision as to the law until the first day of next sittings, because he wished to look at the documents, as this was a novel point.

JUDGMENT

His lordship delivered judgment on the 18th inst. He said that **the affidavits filed showed that the respondent claimed a lien, not as auditor, but as accountant. In his opinion, the question of an auditor's lien did not arise, and, had it done so, he considered that an auditor had no such lien; but that point he did not now decide. In respect of the share register, the accountant had no possible lien on that, but he held that he was entitled to a lien on such books only as he had actually worked upon, in respect of his proper remuneration for work upon those books only. If the parties did not agree upon the sum, there must be an inquiry. Each side would pay its own costs.**

DOVEY AND OTHERS *v.* CORY (NATIONAL BANK OF WALES CASE)*

(Decided by the House of Lords, before the LORD CHANCELLOR, Lord MACNAGHTEN, Lord SHAND, Lord DAVEY and Lord BRAMPTON, 1st August, 1901)

Held that a director, if he acts bona fide, is entitled to rely on the officers of the company to prepare true and honest accounts

This was an appeal from a decision of the Court of Appeal (the Master of the Rolls (now Lord Lindley), Sir F. H. Jeune and Lord Justice Romer), dated 2nd August, 1899, which reversed a judgment of Mr. Justice Wright, dated 27th February, 1899. The hearing before the Court of Appeal is reported in XXV *The Accountant Law Reports*, 127; 15 *Times Law Reports* 517; L.R. [1899] 2 Ch. 627; and 68 L.J.Ch. 634.

The appellant is the liquidator of this bank, and the Metropolitan Bank (of

* [1901] A.C. 477; *The Times*, 2nd August, 1901.

England and Wales) have purchased and taken over its assets and liabilities. The respondent, John Cory, was for some years a director of the National Bank. In the liquidation of the latter a summons was taken out to render the respondent liable—not to creditors, all of whose claims had been satisfied, but to the contributories, in respect of alleged misfeasance: (1) in paying dividends out of capital; (2) in making improper advances to directors; and (3) in making improper advances to customers who were, or were reputed to be, insolvent, and the summons asked that the respondent should be ordered to repay the full amount of all losses caused by such acts of alleged misfeasance with interest and costs. Mr. Cory became a director on 23rd November, 1883, and resigned on 18th December, 1890. The summons asked that the respondent should be deprived of the benefit of the Trustee Act, 1888, and of the Statutes of Limitation, on the ground that the losses arose from the respondent's wrongful acts and fraudulent concealment of the true state of affairs. The appellant's counsel, however, disclaimed the imputation of any moral obliquity on the part of the respondent, but argued the question on the basis of negligence and failure to discharge the duties of a fiduciary position. The transactions complained of were voluminous, and ranged over a series of years, and related to the affairs not only of the head office, but of the branches, which in 1890 were thirty-three. It was, however, found possible by the parties to condense the story within the limits of four volumes and about 1,500 pages. In February, 1893, an agreement was entered into between the National Bank of Wales and the Metropolitan, Birmingham, and South Wales Bank, now the Metropolitan Bank (of England and Wales) Ltd., whereby the latter bought the assets and goodwill and undertook the liabilities and contracts of the former, the value of the assets and goodwill being taken at not less than £110,000. Voluntary resolutions were passed for winding up the National Bank, and Thomas Cory, its former chairman, and the appellant were appointed liquidators. Mr. Thomas Cory subsequently resigned and the appellant became sole liquidator. The alleged amount of improper payments of dividends was £52,986; of loss on advances and credits to directors to 31st December, 1890, £37,731; and of loss on improper advances to customers, £43,087. The whole of the assets were realised or valued, and the appellant Dovey alleged that after discharging the liabilities of the National Bank and crediting it with the value of its assets and £110,000 as its goodwill, there remained a deficiency of assets amounting to £84,392. Calls were made of £2 10s. per share each in July, 1896, and September, 1899. Mr. Justice Wright ordered the respondent to pay £54,787, being £37,000, the aggregate amount of dividends paid to the shareholders in 1887, 1888, 1889 and 1890 (except a part of the last dividend), and as to the balance, interest at 5 per cent. on each of the dividends. The learned judge held that all these dividends were in fact paid out of capital; but he declined to make the respondent liable for improper advances to directors or customers. The Court of Appeal, in an elaborate judgment, delivered by the Master of the Rolls, exonerated the respondent from liability. This decision was affirmed by the noble and learned lords.

JUDGMENT

THE LORD CHANCELLOR: In this case the liquidator of the National Bank of Wales Ltd. appeals against a judgment of the Court of Appeal, whereby Mr. John Cory, the respondent, was discharged from the liability which Mr. Justice Wright's judgment had imposed upon him to pay £37,000 for the benefit of the shareholders of the company in respect of dividends already distributed, and a further sum for interest. Mr. John Cory was a director of the company, and it is for his supposed misconduct in the management of the affairs of the company that this liability was imposed upon him. It is alleged and proved that certain losses have been sustained by the company, and the ground upon which Mr. John Cory is sought to be made liable is the very short and intelligible ground that he was a party to false and fraudulent statements as to the position of the company, and had had a share in causing these losses. The Court of Appeal have acquitted him of any knowledge of what was falsely stated, and Sir Robert Reid, in opening this appeal, stated to your lordships that he did not intend, in arguing for Mr. John Cory's liability, to impute to him any moral obliquity. Now, there is no doubt that there were balance sheets laid before meetings of the shareholders which,

to use the language of the articles of association, were not proper, and which did not truly report as to the state and condition of the company, and did not comply with the requirements of the articles in question in respect of the particular sum which the directors recommended as dividend, that it should be paid out of the profits, but a greater sum was paid out as dividend than would have been paid if certain things had been taken into consideration, and therefore larger than should have been paid. A great part of the judgment, both of Mr. Justice Wright and of the Court of Appeal, is occupied by discussing matters which are not now before your lordships as matters in debate. It is now admitted that Mr. John Cory ceased to be a director in December, 1890. My Lords, I am very clearly of opinion that the judgment of the Court of Appeal is right and ought to be affirmed; but my opinion is entirely based upon the question of fact that he was guilty of no breach whatever, and for reasons which I will refer to hereafter, I am very anxious not to deal with some reasons given for their judgment by the Court of Appeal, which, in the view of the facts that I take, do not arise here; and in what I say I desire to be understood as only dealing with the facts of this particular case. Now, in the first instance, I will assume that the company has sustained loss by the issue of fraudulent balance sheets, by the improper advance of money to the customers of the bank, and that it has also sustained loss by the lending of money to directors without security. With respect to the default involving liability, if Mr. John Cory was conscious of the falsehood it is not necessary to go any further. Like anyone else who is a party to a false statement acted upon to the prejudice of the person to whom it is made, he would be liable to the extent to which his falsehood has inflicted loss on his victims, but after the admission that he has made it is unnecessary to pursue this head of inquiry; he certainly could not be acquitted of moral obliquity if party to a fraudulent statement; but it is said he has so grossly neglected his duty as a director that, though he may not have known the true state of the facts, he ought to have known them, and his breach of duty in that respect renders him liable. In order to see how far this obligation is made out it is necessary to consider what the business of the company was, and what was the position of Mr. John Cory in relation to it. My Lords, I think it is idle to talk in general terms of the duty of a director to look after the concerns of the company of which he is one of the managers without seeing what in the ordinary course of business he ought to do or to have done. Now, there are some things which, of course, must be, or at all events ought to be, apparent to anyone responsible for the conduct of a commercial business, and to apply that observation to the business of which we are speaking—namely, a banking business; but I do not understand that anyone has suggested that there was neglect or default by reason of the absence of some system under which, if honestly carried out, the interests of the bank would have been in that respect secured. It is admitted that (extract from judgment of the Court of Appeal) ‘the company’s principal bank and its head office were at Cardiff, where the directors met and the general manager was in daily attendance. The company had also many branch banks, each with its own manager. The course of business was this. Each branch manager sent weekly to the head office what is called a weekly state—i.e. an account showing how the assets and liabilities of the branch stood, what advances or overdrafts had been made or allowed and to whom, what securities the bank held, and other matters. Every quarter each branch manager made a more formal return to the head office showing the position of the branch and the business done during the past quarter. It was the duty of the general manager to examine these documents and to report to the board anything disclosed by them which required their attention. The weekly states or quarterly returns were in the board room for reference in case of need, but unless attention was called to them the directors did not think it necessary to examine them. The chairman of the directors was Mr. Thomas Cory, a brother of Mr. John Cory. The chairman and the general manager (Mr. Collins) visited each branch bank every year; and, in addition, two skilled inspectors frequently went round and inspected the accounts and reported to the general manager. The accounts of the branch banks appear, however, not to have been separately audited by professional accountants. The auditors employed to examine the company’s accounts and to certify the annual balance sheets and accounts laid before the shareholders only saw the head office books and the returns from the branch offices certified by their respective managers to the head office. These

certified returns formed part of the weekly states, but omitted much that they contained. The minutes of the directors' meetings show that, speaking generally, they attended with reasonable regularity and transacted a large amount of business. No director, unless it was the chairman, attended to any details not brought before the board either by the chairman or by the general manager. Mr. John Cory stated in his affidavit the general course of business at board meetings, and his cross-examination does not substantially differ from the account he there gives. But it is suggested that Mr. Cory is responsible because this and other portions of the system were not faithfully adhered to. And, indeed, what is really made the test of his responsibility is that he did not find out what was fraudulently withheld from his knowledge. So the warning letters of the auditor, which were never suffered to reach him, are suggested as warnings to him which he ought not to have neglected. Again, the insufficient striking out of bad and doubtful debts, by which it is alleged that the amounts paid in dividends to himself and other directors, as well as shareholders, are by a process of reasoning and calculation assumed to be payments out of capital. These things are all assumed to have been done as though done with knowledge and intention, while at the same time the admission is made that there was no evil mind or conscious fraud. Now, I think such things, if done with evil mind and intention, would be fraud, and it comes back again to the proposition that the responsibility must be based upon the assumption that Mr. Cory is responsible because he did not find out the fraudulent knaves by whom he was surrounded. One was his own brother, another was the general manager, and, once I arrive at the conclusion that there were those about him whose interest and object it was to deceive him, I certainly do not think that the things which were designedly concealed from him are things which ought to be relied upon as matters for which he was responsible. In the view I take, the whole of the evidence which is relevant and important to the question: 'Did Mr. Cory knowingly permit the things to be done which were done?' becomes to my mind entirely immaterial if one is to start with the assumption that he knew nothing about them. Dealing with the several heads of charge as they have been formulated in the judgment of Mr. Justice Wright—viz. negligence, breaches of trust in respect of advances made contrary to said articles of association and payment of dividends and of capital—I think each and all of them may be disposed of by the proposition that Mr. Cory was not himself conscious of any one of these things being done, and that unless he can be made responsible for not knowing these things—or, as Mr. Justice Wright put it, he is shown to have exhibited a complete neglect of the duties he had undertaken—the charges are not made out. The charge of neglect appears to rest on the assertion that Mr. Cory, like the other directors, did not attend to any details of business not brought before them by the general manager or the chairman, and **the argument raises a serious question as to the responsibility of all persons holding positions like that of directors—how far they are called upon to distrust and be on their guard against the possibility of fraud being committed by their subordinates of every degree. It is obvious if there is such a duty it must render anything like an intelligent devolution of labour impossible.** Was Mr. Cory to turn himself into an auditor, a managing director, a chairman, and find out whether auditors, managing directors and chairmen were all alike deceiving him? That the letters of the auditors were kept from him is clear. That he was assured that provision had been made for bad debts and that he believed such assurances is involved in the admission that he was guilty of no moral fraud; so that it comes to this—that he ought to have discovered a network of conspiracy and fraud by which he was surrounded, and found out that his own brother and the managing director (who have since been made criminally responsible for frauds connected with their respective office) were inducing him to make representations as to the prospects of the concern and the dividends properly payable which have turned out to be improper and false. I cannot think that it can be expected of a director that he should be watching either the inferior officers of the bank or verifying the calculations of the auditors themselves. The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management. If Mr. Cory was deceived by his own officers—and the theory of his being

free from moral fraud assumes under the circumstances that he was—there appears to me to be no case against him at all. The provision made for bad debts, it is well said, was inadequate, but those who assured him that it was adequate were the very persons who were to attend to that part of the business—and so of the rest. If the state and condition of the bank were what was represented, then no one will say that the sum paid in dividends was excessive. If I assume, as I do, that Mr. Cory acted upon representations made to him which he believed and which as coming from the officers of the bank to whom he was, in my judgment, justified in giving credit, the discussion of whether the dividends actually paid were or were not properly divisible, has no bearing on Mr. Cory's liability, and I am very reluctant to give any opinion upon it, inasmuch as the question may arise when it may be necessary to decide it. I deprecate any premature judgment. Mr. Lords, I am, as I have said, very reluctant to enter into a question which for the reason I have given does not arise here, and into which the Court of Appeal has entered at some length. The only reason why I refer to it at all is lest by silence I should be supposed to adopt a course of reasoning as to which I am not satisfied that it is correct. I doubt very much whether such question can ever be treated in the abstract at all. The mode and manner in which a business is carried on, and what is usual or the reverse, may have a considerable influence in determining the question what may be treated as profits and what is capital. Even the distinction between fixed and floating capital, which in an abstract treatise like Adam Smith's 'Wealth of Nations' is appropriate enough may, with reference to a concrete case be quite inappropriate. It is easy to lay down as an abstract proposition that you must not pay dividends out of capital, but the application of that very plain proposition may raise questions of the utmost difficulty in their solution. I desire, as I have said, not to express any opinion, but as an illustration of what difficulties may arise the example given by the learned counsel in one ship being lost out of a considerable number, and the question whether all dividends must be stopped until the value of that lost ship is made good out of the further earnings of the company or partnerships, is one which one would have to deal with. On the one hand, people put their money into a trading concern to give them an income, and the sudden stoppage of all dividends would send down the value of their shares to zero, and possibly involve its ruin. On the other hand companies cannot at their will and without the precautions enforced by the statute reduce their capital; but what are profits and what is capital may be a difficult and sometimes an almost impossible problem to solve. When the time comes that these questions come before us in a concrete case we must deal with them, but until they do, I, for one, decline to express an opinion not called for by the particular facts before us and I am the more averse to doing so because I foresee that many matters will have to be considered by men of business which are not altogether familiar to a court of law. I move that this judgment be affirmed, and this appeal dismissed with costs.

LORD MACNAGHTEN: I have had an opportunity of reading in print the judgment of my noble and learned friend on the Woolsack, and I desire to express my concurrence in it, and at the same time to guard myself from being understood to assent to all the propositions supposed to have been laid down by the Court of Appeal in this case. I say no more, because it seems to me that when Sir Robert Reid withdrew all charges involving moral obliquity against Mr. Cory, the case was at an end. And I do not think it desirable for any tribunal to do that which Parliament has abstained from doing—that is, to formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs. There never has been, and I think there never will be, much difficulty in dealing with any particular case on its own facts and circumstances, and, speaking for myself, I rather doubt the wisdom of attempting to do more. I understand from my noble and learned friend Lord Shand that he also takes this view.

LORD DAVEY: I agree with your lordships in thinking that the appellant has not succeeded in making out a case for the relief which he asks against the respondent. The appellant seeks to make the respondent liable under three heads: (1) in respect of losses incurred by advances of money which he alleged that the

respondent and the other directors of the bank negligently made to irresponsible persons, and without sufficient security; (2) in respect of advances to the directors themselves, which he alleges were made contrary to the express provisions of the articles of association; (3) in respect of sums paid to the shareholders (including the respondent himself) by way of dividend on their shares, which he alleges were paid out of the capital of the bank, and not out of profits. In fact he alleges there were no profits out of which such dividends could properly be paid, and that an apparent profit was created only by including as assets debts known to be bad and irrecoverable. As regards the first two heads of claim, Mr. Justice Wright, as well as the Court of Appeal, has held that the claims cannot be sustained, and as I agree with the reasons which have been assigned for so holding I need not trouble your lordships by repeating them. As regards the third head of claim, the case as presented at your lordships' bar has been very much narrowed by the admission of the appellants' counsel that the respondent ceased to be a director in December, 1890, and his acceptance of the decision of the Court of Appeal that the Statute of Limitations applies so as to bar the recovery of any sums paid away prior to six years before the commencement of the proceedings. The claim is thus confined to the three dividends paid in July, 1889, December, 1889, and July, 1890. My Lords, I think it appears from the evidence that in the balance sheets upon which these dividends were recommended by the directors bad and irrecoverable debts were in fact included amongst the assets of the company, and that if those debts had been written off (as they ought to have been) the balance sheets would not have shown any profit out of which the dividends could have been paid. But before proceeding to discuss the evidence upon which it is sought to fix the respondent with responsibility, I will say a few words with regard to the law upon the subject with a view to ascertain exactly what it is the appellant must establish. After analysing and discussing several authorities, his lordship proceeded: The respondent, in his affidavit, states generally that he was from first to last under the honest and genuine belief that the affairs of the company were in a sound and solvent condition, and that its business was being carried on at a profit, and that its net profits for the time being were amply sufficient to justify the dividends which were from time to time during his directorship paid to the shareholders. And he adds that the general manager and branch managers were, so far as he knew, men of unquestioned competence and integrity, and that he and his co-directors were compelled by the magnitude of the business and the exigencies of the case generally to rely upon (and he did rely upon) these officials in all ordinary matters relating to the accounts of customers and other questions of detail. And he deals specifically with the various matters alleged in the liquidator's evidence on the same lines. The respondent was cross-examined on his affidavit at great, but not unnecessary, length. I am not, I think, doing injustice to the appellant's case when I say that reliance was chiefly placed on the 'weekly states' and 'quarterly returns' made by the branch managers, or that, if he cannot succeed in fixing the respondent with liability on these documents, his case fails. These returns were laid on the table in the board room at each meeting of the directors. The comparative analysis of them, made by the skilled accountant who advises the appellant, does, I think, show that certain accounts which were treated as good by the general manager in the preparation of the balance sheets submitted by him to the directors, were, in fact, irretrievably bad, and it is difficult to acquit the general manager of improper conduct in including them as assets. The respondent says in his affidavit that the 'weekly states' consisted each week of a very large and voluminous pile of sheets, which it would have taken the directors a couple of days to go through, and that it was the duty of the general manager to go through the weekly states, with the letters of the branch managers accompanying them, and to place upon the agenda any points arising upon them which he considered ought to be brought to the attention of the directors; and upon the discussion of such points the documents were, when necessary, referred to; but, except in such cases, the weekly states were not consulted by the directors, but they relied on the general manager going carefully through them and drawing their attention to any matter requiring their consideration. On cross-examination he adhered to this statement. He added that the chairman also went through them, often individually, and he did so for the board.

He admitted that before recommending a dividend he did not look at all the accounts or look at the books themselves, but he said that the directors looked at the documents which were put before them by the manager—the amount which he considered was doubtful and bad—and they made a reserve for it. He also said that it was never brought before him that amounts due from bankrupt debtors were included in the balance sheet of each year, and he never heard of any single case of that kind. It further appeared from the evidence of other witnesses that the branches of the bank were regularly visited and their books examined by the chairman and two inspectors. In this state of the evidence, I ask whether the course of business at the board meetings as described by the respondent was a reasonable course to be pursued by the respondent and other directors, or whether the knowledge which might have been derived from a careful and comparative examination of the weekly states and quarterly returns from the different branches of the bank ought to be imputed to the respondent, or, alternatively, whether he was guilty of such neglect of his duty as a director as would render him liable to damages? I do not think that it is made out that either of the two latter questions should be answered in the affirmative. I think the respondent was bound to give his attention to and exercise his judgment as a man of business on the matters which were brought before the board at the meetings which he attended, and it is not proved that he did not do so. But I think he was entitled to rely upon the judgment, information and advice of the chairman and general manager, as to whose integrity, skill and competence he had no reason for suspicion. I agree with what was said by Sir George Jessel in *Hallmarks'* case (9 Ch.D. 329), and by Mr. Justice Chitty in *In re Denham & Co.* (25 Ch.D. 752), that directors are not bound to examine entries in the company's books. It was the duty of the general manager and, possibly, the chairman to go carefully through the returns from the branches, and to bring before the board any matter requiring their consideration, but the respondent was not, in my opinion, guilty of negligence in not examining them for himself, notwithstanding that they were laid on the table of the board for reference. The case is, no doubt, one of some difficulty, but the appellant has not made out to my satisfaction that the respondent wilfully (as that term is explained in the cases I have referred to) misappropriated the company's funds in payment of dividends. My Lords, what I have said is sufficient for the decision of this appeal. But I desire to express my dissent from some propositions of law which were laid down in the Court of Appeal, and upon which your lordships thought it right to hear the respondent's counsel. The learned judges seem to have thought that a joint-stock company, incorporated under the Companies Acts, may write off to capital losses incurred in previous years, and may in any subsequent year, if the receipts for that year exceed the outgoings, pay dividends out of such excess without making up the capital account. If this proposition be well founded it appears to me that a company whose capital is not represented by available assets need never trouble itself to reduce its capital, with the leave of the Court and subject to the other conditions imposed by the Act of 1877, in order to enable itself to pay dividends out of current receipts.* My Lords, it may be that I have misapprehended the statement of law intended to be made by learned judges in the Court of Appeal. I think that is possible, because I find that in *Verner v. General and Commercial Investment Trust* ([1894] 2 Ch. 124, at page 266): 'Perhaps', Lord Lindley says, 'the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk or lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law.' I reserve my opinion as to the effect of an actual and ascertained loss of part of the company's fixed capital, as in the case put by Mr. Swinfen-Eady of a loss of a ship uninsured. But, subject to this observation, I think that the statement of law in the passage I have quoted is not open to objection, and it is only because the learned judge appears to me to have departed from it in his judgment in the present case that I have troubled your lordships with these remarks. I agree that the appeal should be dismissed.

Lord BRAMPTON concurred.

* In this connection see now *Ammonia Soda Co. Ltd. v. Chamberlain*, 1918.—Ed.

BOND v. THE BARROW HÆMATITE STEEL CO. LTD.*

(Decided by FARWELL, J., in the Chancery Division, on 18th January, 1902)

Held that preference shareholders cannot claim to receive dividends out of current profits as a matter of right, and without regard to such provision for reserves as the directors may think needful.

Judgment was delivered in this important action, which was before the Court last sittings. The facts and arguments sufficiently appear from the judgment.

Mr. Justice FARWELL: The defendant company were incorporated in the year 1864 with a capital of £150,000, which has since been first increased and subsequently reduced and now stands at £1,528,275, divided into 150,000 ordinary shares of £7 10s. each, 377 8 per cent. preference shares of £75 each, and 50,000 preference shares of £7 10s. each. The plaintiffs are holders of some of each of these classes of preference shares, and they claim, on behalf of themselves and all other holders of preference shares, to be paid the dividends and arrears of dividends on their shares out of the profits which they allege that the company has made in the years 1898, 1899 and 1900. No dividend has been paid on the 8 per cent. preference shares since 1898, or on the 6 per cent. preference shares since 1896. The preference shareholders have no vote in respect of these shares. The profit and loss account for the year 1898 shows a balance described as 'net profits for the year 1898' of £65,803 7s. 3d., and of this £20,000 was carried to reserve account making it £40,000, and £10,418 10s. was carried forward. The profit and loss account for the year 1899 shows a balance described as 'net profit for the year 1899' of £89,018 17s. 6d., and this was carried forward pending the decision of the Court on an application for the reduction of the capital of the company, to which I will refer presently. The profit and loss account for the year 1900 shows a balance of £157,605 12s. 11d., which is provisionally brought forward. The report for the year 1898 contains the following statement: 'The shareholders are aware, both from the balance sheets themselves and the auditors' certificates which have accompanied them, that for some years past no depreciation has been written off the amounts at debit of land, buildings, works, fixed plant and mining leases. The directors have carefully considered the matter, and, having regard to the fact that many of these assets are more or less of a wasting character, they are of opinion that the time has arrived when a careful revision of their value should be made. It is, however, a subject which in all its bearings requires most mature consideration, and the deliberations of the directors are not sufficiently advanced at the present time for them to submit any recommendation to the shareholders.' Accordingly, in the year 1899 special resolutions were passed for the reduction of the capital of the company. The petition for the confirmation of these resolutions came before the Court in August, 1900 (2 Ch. 846) and was opposed by some of the preference shareholders, and the petition was dismissed by Mr. Justice Cozens-Hardy, and his order was confirmed by the Court of Appeal ([1901] 2 Ch. 746). Some, but not all, of the present plaintiffs appeared and opposed this petition, and the petition was dismissed on the ground that the alleged loss had not been proved to the satisfaction of the Court, and also by Mr. Justice Cozens-Hardy on the ground that the amount standing to the credit of the reserve fund and the £89,018 17s. 6d. profit for the year 1899 were applicable to make good loss of capital so far as they would extend. The plaintiffs in the present action are now claiming that these sums and the balance to the credit of profit and loss account in 1900 are not so applicable but belong to them by contract, and it is argued on behalf of the defendants that Mr. Justice Cozens-Hardy's order creates an estoppel, and this may possibly be correct so far as regards any of the plaintiffs who appeared and opposed the petition. But this is not pleaded, and as there are other plaintiffs who did not appear on the petition, and who could sue on behalf of themselves and all other preference shareholders who did not oppose the petition, I do not think it necessary to express any conclusive opinion on this point. Nor can I regard Mr. Justice Cozens-Hardy's decision as a precedent disposing of this case, for the points argued before me were not before him and that by no fault of the plaintiffs, because the contentions that they now raise could not have been put forward by them in support of their opposition to the petition, but were adverse to such opposition, and should, if

* [1902] 1 Ch. 353; *The Times*, 17th January, 1902.

urged at all, have been urged by the company. The contention of the plaintiffs in this action is that they are entitled by contract to be paid a preferential dividend out of the balance to the credit of the profit and loss account in each year, and that the company cannot appropriate any part of such balance to reserve, or carry over one shilling until they have been paid in full. There is no suggestion of want of bona fides on the part of the directors or of the company. The defendants contend that this is not the true construction of the special resolutions creating the preference shares, and that, if it is, the balance to the credit of profit and loss for any year is not necessarily such profits of the company as are properly applicable to dividend, but that if the Court is satisfied by the evidence that there have been ascertained losses and depreciations of capital assets exceeding the amount of the balances, these losses must be made good before any dividend can be paid. The first point depends on the construction of the original articles and the special resolutions creating the preference shares, for it is not contended that if the preference shareholders have such contractual rights as they claim, the company can by subsequent special resolutions deprive them of such rights or of any part thereof. Article 43 provides as follows: 'Any capital raised by the creation of new shares shall be considered as part of the original capital, and shall be subject to the same provisions with reference to the payment of calls, the forfeiture of shares on nonpayment of calls or otherwise, as if it had been part of the original capital, except that it shall be lawful for the company in general meeting, by special resolution as aforesaid, to direct that the new shares shall have such priority in respect of dividends as it shall deem expedient.' This article, in my opinion, provides that all new shares shall be subject in all respects to all the provisions of the articles, except only that dividends payable on new shares may rank in priority to, instead of *pari passu* with, ordinary shares. For this purpose it is necessary only to introduce modifying words in article 95, and then the whole *fasciculus* of clauses relating to dividends (95 to 101) apply. It is argued that the provisions as to the declaration of a dividend do not apply to shares on which a fixed preferential dividend is payable. In my opinion, this is not so. The necessity for the declaration of a dividend as a condition precedent to an action to recover is stated in general terms in *Lindley on Companies* (fifth edition, p. 437), and where the reserve fund article applies, it is obvious that such a declaration is essential, for the shareholder has no right to any payment until the corporate body has determined that the money can properly be paid away. It is urged that this puts the preference shareholders at the mercy of the company, but the preference shareholders came in on these terms and this argument does not carry much weight in an action such as this where bona fides are conceded. The opposite conclusion might enable the preference shareholders to ruin the company, and would certainly lead to great inconvenience in enabling them to compel the payment out of the last penny without carrying forward any balance. Granted that it is a hardship to go without dividend for a time, this hardship presses more heavily on the ordinary shareholders, who have to wait until the preference shareholders have received all arrears before they can get anything. It was urged that article 97 providing for the reserve fund cannot apply to preference shares, because one of its objects is to equalise dividends, but I cannot see that the mention of one object which is not applicable is any reason for excluding those objects which are applicable, and which are really for the benefit of all the shareholders. On the articles as they stand, I have no doubt that the true construction is that which I have stated. But it is contended that the special resolutions have created larger rights, and it was, in my opinion, competent to the company by such resolutions to alter article 43. Now the 8 per cent. preference shares are created by resolutions of 1872 in these terms: '(1) This company will agree to purchase from the Barrow Rolling Mills Co. Ltd. the two furnaces erected by that company, and the land purchased by them, and any other property of which the Rolling Mills Co. may be possessed. (2) The consideration for the purchase shall be the sum of £37,700 in preference shares of this company, bearing interest at 8 per cent. per annum from the 1st of January last, such preference shares to be issued to the present shareholders in the Rolling Mills Co. in proportion to their holdings. (3) The directors are authorised to issue preference shares to the amount of £37,700, bearing interest at 8 per cent. per annum in perpetuity, for the purpose of carrying out the above arrangement. (4) The holders of the above-mentioned preference shares

shall be entitled to attend the general meetings of this company, but they shall not be entitled in virtue of such shares to vote, or to interfere in any way in the company's proceedings, nor shall they, in virtue of such shares, be eligible as directors of the company.' In my opinion there is nothing whatever in this to alter any of the articles as I have construed them. Stress has been laid on the word 'interest'; but in my opinion that word has slipped in *per incuriam*, and should be read as 'dividend', as indeed is done when this resolution is referred to in the special resolutions of 1876, to which I shall have to refer presently. Interest is not an apt word to express the return to which a shareholder is entitled in respect of shares paid up in due course and not by way of advance. Interest is compensation for delay in payment, and is not accurately applied to the share of profits of trading, although it may be used as an inaccurate mode of expressing the measure of the share of such profits. It is impossible, in my opinion, to give to the word used as it is in this case so pregnant a meaning as the plaintiffs derive, reading it as equivalent to an alteration of the articles and as creating a right overriding the valuable and possibly essential article providing for reserve funds. The 6 per cent. preference shares present more difficulty. They were created by resolutions of 1876 as follows: '(1) The capital of the company shall be and is hereby increased by the addition thereto of 50,000 preference shares of £10 each, entitling the holder to a fixed dividend at the rate of £6 per centum per annum on the amount for the time being paid up in respect of such shares. (3) The holders of the said new preference shares shall be entitled to a dividend thereon only after payment of the interest from time to time payable in respect of the mortgage and bond or debenture debts of the company, and after payment of a dividend at the rate of £8 per centum per annum on the preference shares of the company, amounting to £37,700, created by special resolutions passed and confirmed at extraordinary general meetings of the company in the year 1872; and in any case in any year the net profits of the company shall not be sufficient for the payment in full of the dividends on such new preference shares, the net profits of any subsequent year shall (after payment thereof of interest on the mortgage bond or debenture debts of the company, and of dividends of the said £8 per cent. preference shares) be applied in payment to the holders of the said new preference shares of the amount by which the dividends of any previous year or years may have fallen short of the fixed rate of £6 per cent.' The third resolution is not very happily worded, but I have come to the conclusion that this and the first resolution read together are merely a verbose statement of a bargain that the holders of the 6 per cent. shares are to have a fixed 6 per cent. cumulative preferential dividend, subject to the rights of the debenture-holders and the 8 per cent. preference shareholders. I think that the words 'only after payment, &c.', in No. (3) are restrictive words, equivalent to 'subject to' and do not create new rights by rescinding the articles relating to declaration of dividends, creation of reserve fund and the like. The only difficulty that I have felt has been created by the latter part of No. (3), beginning 'the net profits of any such year'. I feel the difficulty of limiting the generality of the term 'net profits', but, on the other hand, it is only the arrears to which this provision applies, and it would be strange that the preference shareholders should have to allow a reserve fund to be formed so far as their current year's dividend was concerned, but should be entitled to sweep up everything in respect of past arrears. I have come to the conclusion that the use of the words 'net profits' is not sufficient to rescind the articles to which I have referred, but that the resolution must be read as subject to the provisions of those articles. For the reasons that I have stated the plaintiffs' case fails.

But another point has been taken by the defendants and, as evidence has been adduced and considerable argument has been addressed to it, I feel bound to state the conclusion at which I have arrived with respect to it. The construction is that, even if the plaintiffs were right in their construction of the articles, the company could not legally pay them the dividends that they claim because there are no profits properly so called out of which they can be paid, and that any such payment, if made, would be made out of capital. It has been proved to my satisfaction (and, indeed, Mr. Jenkins very properly admitted that he could not dispute that the result of the evidence was) that the company has sustained an actual ascertained and realised loss of capital to an amount exceeding £200,000, and has also lost capital by estimate and valuation to an amount

exceeding £50,000. The various sums claimed by the plaintiffs as available to pay their dividend amount to about £240,000. If, therefore, these ascertained and estimated losses have to be made good before any dividend can properly be paid, there are obviously no funds out of which to pay dividends. The defendants allege and the plaintiffs deny that the company are bound to make good these losses before paying any dividend. The question is one of very considerable difficulty on the authorities, but the result of these authorities is, in my opinion, that there is no hard and fast rule by which the Court can determine what is capital and what is profit. 'The mode and manner in which a business is carried on and what is usual or the reverse may have a considerable influence in determining the question.' (Per the Lord Chancellor in *Dovey v. Cory* [1901], A.C. 486.) 'It may be safely said that what losses can be properly charged to capital and what to income is a matter for business men to determine, and it is often a matter on which the opinion of honest and competent men will differ. There is no hard and fast legal rule on the subject.' (Per Lord Justice Lindley [1899], 2 Ch. 670.) It is, however, necessary to bear in mind that the two propositions—(1) that dividends must not be paid out of capital, and (2) that dividends may only be paid out of profits—are not identical but diverse. The first is the requirement of the statutes, and cannot be dispensed with; the latter is in Table A in the articles of the particular company, and is one of the regulations of the company which has to be construed. A company which has a balance to the credit of its profit and loss account is not bound at once to apply that sum in making good an estimated deficiency in value of its capital assets. It may carry it to a suspense account or to reserve, and if the assets subsequently increase in value the amount neither has been nor will be part of the capital. If, therefore, a part of such balance is used in paying dividends, such dividend is not paid out of capital because the sum has never become capital, although it still remains a question whether it has been paid out of profits or not. It has been pointed out by Lord Justice Lindley in *Lee v. Neuchatel Asphalte Co.* (41 Ch. 1) that there is nothing in the statutes requiring the company to keep up the value of its capital assets to the level of its nominal capital. The requirement is merely negative, that dividends shall not be paid out of capital, and the balance to the credit of profit and loss account does not automatically become part of the capital assets because the value of the actual capital assets has depreciated to an amount equal to or exceeding such balance. The real question for determination, therefore, is whether there are profits available for distribution, and this is to be answered according to the circumstances of each particular case, the nature of the company, and the evidence of competent witnesses. There is no single definition of the word 'profits' which will fit all cases. Take, for instance, Professor Marshall's definition (*Economics*, edition of 1883, p. 142): 'The excess of the receipts from the business during the year over the outlay for the business, the difference between the value of the stock and plant at the end and at the beginning of the year being taken as part of the receipts or as part of the outlay according as there has been an increase or decrease of value.' I am precluded from adopting this in its entirety by authorities which are binding on me, because, in the definition, 'stock and plant' obviously include both fixed and circulating capital as defined at p. 134 of the same treatise. See, for instance, Lord Lindley's judgment in *Verner's case* ([1894] 2 Ch. at p. 266), where he says: 'Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up.' I do not understand his lordship to be laying down a general and universal rule that in every company fixed capital may be sunk and lost, but that there are companies in which that may be the case. All the authorities, however, agree, I think, that circulating capital must be kept up. Now in the present case the £200,000 realised loss arises by the surrender of the leases of certain mines, by the pulling down of certain furnaces, and on the sale of certain cottages. The company is a smelting company on a very large scale, and for the convenience of its works and by way of economy they acquired the leases

of the surrendered mines in order to supply themselves with their own ore instead of buying it as required. The ore was used exclusively for the purpose of the company's works. The mines were drowned out and the cost of pumping them out was prohibitive. The company, therefore, surrendered the leases, pulled down the blast furnaces, and sold the cottages connected therewith. Now the evidence before me is all on one side. The plaintiffs called none, and Sir David Dale and the defendants' other witnesses all agree that in a company of this nature these items ought to come into the account before any profit can be said to be earned, and my own opinion coincides with theirs, inasmuch as I think that the money invested in those items is properly regarded in this company as circulating capital. Suppose the company had bought enormous stocks of ore sufficient to last for ten years, it could hardly be said that the true value of so much of this as remained from time to time ought not to be brought into the balance sheet, and I can see no difference for the purpose of the account between ore *in situ* and ore so bought in advance. The blast furnaces and cottages are mere accessories to the ore, and resemble a building for housing the stores bought in advance already mentioned. There is more difficulty about the remaining £50,000. I think that the onus is on the plaintiffs to show that it is fixed capital and that in a company of this nature such fixed capital may be sunk or lost. They have not done this, and the evidence, so far as it goes, is the other way. But this is not an actual loss, but depreciation by estimate. The plaintiffs really relied on *Lee v. Neuchatel Asphalte Co.* as an authority for this proposition as a universal negative—viz. 'that no company owning wasting property need ever create a depreciation fund'. In my opinion that is not the true result of the decision. It must be remembered that in that case there had been no loss of assets. The company's assets were larger than at its formation (see page 15) and the Court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund. For instance, I cannot think that it would be right for the defendant company to purchase out of capital the last two or three years of a valuable patent and distribute the whole of the receipts in respect thereof as profits without replacing the capital expended in purchase. It is for the Court to determine in each case on evidence whether the particular company ought, or ought not, to have such a fund. There is no doubt as to the opinion of the witnesses in this case, and, further, the opinion of the directors cannot be altogether disregarded. The Courts have, no doubt in many cases, overruled directors who proposed to pay dividends, but I am not aware of any case in which the Court has compelled them to pay when they have expressed their opinion that the state of the accounts do not admit of any such payment. In a matter depending on evidence and expert opinion it would be a very strong measure for the Court to override the directors in such a manner. I have made no distinction between the realised loss and the estimated loss, because the witnesses declined to recognise any such distinction, and also because the decided cases deal only with the distinction between floating and fixed capital, and do not distinguish between realised and estimated loss, and it would serve no useful purpose for me to express any opinion on the subject. The result is that the action fails, and must be dismissed with costs.

SHORT & COMPTON v. BRACKETT*

(Decided by His Honour Judge TINDAL ATKINSON, in the Colchester County Court, on 6th May, 1904)

Held that an accountant making an investigation of accounts for an incoming partner is entitled to assume that the books are correct

Messrs. Short & Compton, chartered accountants of Colchester, sued Mr. Brackett, of the Hythe ironworks, to recover 30 guineas for services rendered in the preparation of certain accounts, and there was a counterclaim for £139 damages for alleged negligence on the part of the plaintiffs.

Mr. Jones said Mr. Brackett was proposing to take a partner, and employed the plaintiffs to prepare accounts from his books, which would show the amount of the profits and the goodwill. The return furnished by Messrs. Short & Compton

* *The Accountant* L.R. [1904] 8.

showed that the profits during a period of three years and two months had been £929. Nine months afterwards Messrs. Short & Compton sent in their bill, when Mr. Brackett wrote stating that he had recently discovered that, during the period covered by their investigation, a certain clerk of his was deficient in his account to the extent of £111, and alleging that, owing to plaintiffs' failure to detect this, he had lost in the same way another £128. He added that, under the circumstances, he declined to pay plaintiffs' account. Mr. Jones added that the clerk mentioned, 'who appeared to have since been allowed to abscond', seemed each week to have made out the wages bill for a larger amount than was due to the men, and had himself kept the balance. This, Mr. Jones urged, could not have occurred but for the slipshod way in which Mr. Brackett kept his accounts. Messrs. Short & Compton, replying to Mr. Brackett's letter, stated that they were in no sense responsible for the entries in the books—their responsibility began and ended in putting before Mr. Brackett the result of his trading.

Mr. Compton said he was not instructed to audit, but merely to make up the accounts required from the books.

Mr. W. M. Blake corroborated.

Mr. C. W. Cornish, Fellow of the Institute of Chartered Accountants, said that in the case of preparation of a balance sheet from books the totals in the books would be assumed to be correct without investigation, and it would not be the duty of an accountant to examine vouchers, in which term he included wages books.

Mr. Macklin urged that one of the primary duties of an accountant was to ascertain that accounts were accurately kept. Mr. Brackett placed before plaintiffs all his books, and asked them to make a thorough investigation.

With regard to the disappearance of the clerk alluded to, the defendant said he sent him off on the day he discovered the deficiency.

Called for the defendant, Mr. Ernest H. Frith, a member of the Institute of Chartered Accountants, of London, said he considered that it was the duty of an accountant, when making up accounts in connection with the admission of a new partner, to investigate vouchers and the wages book. He agreed that the wages book was of the nature of a voucher and in the present case could not be treated as a book of account.

Cross-examined: The fact that the principal of the business himself drew the wages cheques would make no difference to his desire to see wages book.

JUDGMENT

His Honour Judge TINDAL ATKINSON held that, having regard to the object for which they were employed, the plaintiffs were entitled to assume that the figures appearing in the defendant's books as paid for wages were correct, and in view of the fact that at the time there was no suspicion of any defalcations by the defendant's clerk alluded to, he thought there was no negligence on their part. Therefore judgment would be for plaintiffs on the claim with costs, and the counterclaim would be dismissed with costs.

LONDON OIL STORAGE CO. LTD. v. SEEAR, HASLUCK & CO.*

(Decided before Lord ALVERSTONE, C.J., and a Special Jury in the King's Bench Division, on 1st June, 1904)

Held that it is the duty of the auditor of a company to take proper steps to verify the existence of assets stated in the balance sheet

This was an action for damages for alleged negligence in auditing the plaintiff company's accounts. The defendant firm denied that they had been guilty of negligence, and said that the alleged loss of £760 had been caused by negligence on the part of the directors of the plaintiff company in entrusting so much money to their cashier.

Mr. Bankes stated that the defendant firm consisted of a Mr. Hasluck, who for many years had been the auditor of the plaintiff company, which was incorporated in 1885 to take over a business, till then carried on by Ingall, Phillips & Co.,

* [1904] 31 *The Accountant* L.R. 1.

consisting in the storage and lighterage of oil. The plaintiff company had three wharves on the River Thames—Palmer's, Melhuish's and Dudgeon's. The defendant had been the auditor of the company from the first, and it was his duty under the articles to audit the accounts and 'to certify the correctness of the financial statement' for the purpose of the yearly balance sheet, in which there appeared a sum representing cash in hand, and it was in reference to that sum that the plaintiffs alleged that Mr. Hasluck, through his clerks, had been guilty of negligence. One of the officials of the company had been a Mr. Frederick R. Clarke, who had been taken over from Messrs. Ingall when the company was formed, and who had at first been book-keeper and cashier, but was later also appointed secretary at the city office. At that office a petty cash book was kept, in which the cash balance appeared, and Mr. Hasluck's clerks entered in the balance sheet the amount of petty cash that appeared in the petty cash book, but they never troubled to find out whether Mr. Clarke had that balance in hand or not. Till 1902 nothing was suspected, but Mr. Clarke was then seized with a paralytic stroke and had ever since been in a pitiable state and could not be called as a witness. His duties were taken over by Mr. Hubble, who found in the cash box about £30, though the petty cash book showed a balance of £796, the balance having gradually increased from £21 in 1897 to £796 in 1902. Mr. Hasluck's attention was called to the matter and he said that some people never saw further than their noses. Counsel submitted that the circumstances were suspicious and ought to have put the auditor on inquiry.

Mr. Thomas George Redgrove, the plaintiffs' manager, gave evidence in support of counsel's opening. In cross-examination he said that Mr. Clarke had always been a trusted servant of Messrs. Ingall.

Mr. Henry Thomas Hubble, who had been Mr. Clarke's assistant, and who succeeded him, stated that the petty cash book was kept in a safe of which Mr. Clarke kept the key. When Mr. Clarke was there witness had no access to it. The only occasion when Mr. Clarke was absent for more than a day or two was in 1900.

Mr. George B. Gane, a director of the plaintiff company, said that he had had complete confidence in Mr. Clarke. Witness never asked him how much cash he had in hand, nor did he look at the entries in the petty cash book.

Mr. Isaacs, for the defence, said that Mr. Hasluck had acted as auditor at 35 guineas per annum, and this involved the attendance of his clerks at the office for six or eight weeks. In considering what his duties were, the amount of his remuneration ought to be taken into consideration. It was extraordinary that the directors never took the trouble to ask Mr. Clarke how much he had in hand. There was nothing to excite Mr. Hasluck's suspicions. The directors were not suspicious, and yet they said that Mr. Hasluck ought to have been. An auditor was entitled to act upon the representation of a trusted servant of the company. The plaintiffs had not proved that the money was not taken after the last audit. If it was, the auditor could not have found out the deficit.

Mr. Lawrence Hasluck said that he had no reason to doubt Mr. Clarke. Witness knew the confidence reposed in him by the directors. Witness, having ascertained the creation of an asset by vouching items on both sides, did not ascertain the actual existence of it. The amounts shown by the books to be in hand never excited his suspicion. Witness's remarks about people not seeing further than their noses referred to the directors and not to his own clerk.

Mr. Bankes: You do not suggest that your duties depend on the amount of your remuneration?—No, but the Court of Appeal have suggested it.

Witness considered that his duties ended when he had seen that the entries in the books created an asset. But if there was any ground for suspicion he should report the matter to the directors.

THE LORD CHIEF JUSTICE, in summing up to the jury, said: Gentlemen of the jury, this is an important case, and the law on the matter you will be good enough to take from me. If I direct you wrongly I can be put right afterwards. It is your duty to take the law from me, but the facts will be entirely for you; and if I, in the course of my address to you, indicate any opinion on the facts, do not think it is meant to dictate to you, but only to direct your attention to the points for your consideration as they occur to one having had some experience of accounts of this kind.

The case is of importance, in the first place, to the parties themselves, because the claim made against a professional gentleman is for a considerable sum, some hundreds of pounds, and it is important for the reason Mr. Bankes points out, that it raises an important question as to the duty of auditors. The best thing I think I can do to make it clear is to direct you as best I can as to the law of this case, and then go through the facts bearing upon the question of law, so that we may be able, if we possibly can, to keep our heads clear in considering how the case has to be dealt with.

Now, there are two or three matters which I think you should dismiss from your minds altogether. You have not to consider for a moment whether Mr. Hasluck has been sufficiently remunerated or not. What Mr. Bankes said is perfectly right. He has accepted the position and duties of a auditor, and you have not to consider, aye or no, if he has had a sufficient amount, you have also not to consider as a substantive matter whether or not the directors have been negligent. I entirely agree with the view of the law as explained to you by Mr. Bankes, that the auditor cannot shelter himself for any breach of duty under the neglect of the directors; he is there to do his duty to the company; the only point on which the conduct of the directors may become material is upon the subordinate question as to whether there is anything to arouse the suspicion of the auditor, and whether or not the loss has really been occasioned by the auditor's conduct.

Now, dismissing these two points, except so far as I may have to refer to one later on, let me tell you the duty of the auditor. The auditor is an officer contemplated by law to protect the interests of the company and its shareholders as such; he is there having certain duties prescribed by Act of Parliament, certain powers prescribed by Act of Parliament, and certain powers prescribed by the articles of association of this company. They may vary, but not very materially, in the case of different companies. We have simply to do with this company. The auditor most undoubtedly does undertake very considerable responsibilities, and is liable for the proper discharge of his duties, and if by the neglect of his duties, or by want of reasonable care, he neglects his duty, and damage is caused to the company as such, he is responsible for that damage. I will not adopt any fanciful expression which may be quoted from any particular judgment, but he has got to bring to bear upon those duties reasonable and watchful care, he has got to discharge those duties remembering that the company look to him to protect their interests. He is not, however, supposed to be a man constantly going about suspecting other people of doing wrong, and that is the only respect in which, I think, Mr. Bankes in his most able speech pressed the matter a little too high. While Mr. Hasluck has by the exercise of due and reasonable care to see that all the officials of the company are doing their duty properly in so far as the accounts are concerned, he is not bound to assume when he comes to do this duty that he is dealing with fraudulent and dishonest people; and there comes in the most important consideration from one point of view—perhaps more important than the other, though I do not think of such substantial weight in this matter—if circumstances of suspicion arise, it is the duty of the auditor, in so far as those circumstances relate to the financial position of the company, to probe them to the bottom.

Now, I have stated, I hope clearly, the general position of the auditor, and I do not think it necessary to elaborate it at very great length, beyond reminding you of certain specific articles, which in this particular case do prescribe the duty of the auditor. I thought when Mr. Bankes opened the case, and I still think, he did not in any way overstate the duty that falls upon an auditor in connection with such articles of association as these. Whether or not he has applied the rule correctly to the facts is a matter that you will have to consider later on. The articles provide: 'Once in every year—namely preparatory to each ordinary general meeting—the accounts of the company shall be examined and the correctness of the financial statement ascertained by one or more auditor or auditors.' They further provide that 'every auditor shall be supplied with a copy of the financial statement intended to be laid before the next ordinary meeting, and

it shall be his duty to examine the same with the accounts and vouchers relating thereto'. And further: 'He may, at the expense of the company, employ accountants or other persons to assist him in investigating such accounts, and he may in relation to such accounts examine the directors or any officer of the company.' Although this is written down in writing in these articles of association, which I gather were dated somewhere about the year 1885, they really do not do much more than put in plain and simple language that which would be the duty of an auditor almost derived from his position, but it is of importance to remember that in order to strengthen in one sense the hands of auditors, and at the same time to make it clear that their duties were not those of guarantors for the honesty of servants, were not an undertaking to the company that there had been no fraud or crime committed upon them. Section 23 of the Act of 1900 also specifies the duty of the auditor in such plain language that I will venture to detain you for a moment by reading it to you: 'Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of the auditors, and the auditors shall sign a certificate at the foot of the balance sheet stating whether or not all their requirements as auditors have been complied with, and shall make a report to the shareholders on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office; and in every such report shall state whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as shown by the books of the company.' Now, you must not think that those words 'as shown by the books of the company' excuse the auditor from making proper inquiries into any particular entry in the books. The question always becomes, what, under the circumstances of the case, is a proper inquiry to make in every particular case; and that is why, although it is quite easy for me to lay down to you in general terms what the duty of an auditor is, it is very much more difficult for you, or for anybody else—for me or for you either—to apply that duty to the particular case.

That is why I wish for a very few moments to consider with you the application of this duty to the facts of this particular case. In the same way, Mr. Isaacs is quite right in saying to you, as I have already indicated, that the auditor is not bound to assume that people are dishonest. On the contrary, he is entitled to think that they are honest, and I only read to you for the purpose of an observation I wish to make the passage in which that is put in the Court of Appeal: 'He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind he is only bound to be reasonably cautious and careful'.

Now, I think the best concluding direction I can give to you for which I am responsible is, that he must exercise such reasonable care as would satisfy a man that the accounts are genuine, assuming that there is nothing to arouse his suspicion of honesty, and if he does that he fulfils his duty; if his suspicion is aroused, his duty is to 'probe the thing to the bottom', and tell the directors of it, and get what information he can. And apart from the circumstances of this case, I think Mr. Hasluck made an answer which shows that he appreciated his duty when he said, 'Had I any reason to think that the amount of cash retained at the city office was too much, I should have gone to the directors and asked for an explanation; that would have been my duty', and so far as I may express an opinion, I think that is a true view of what his duty would have been under the statute and the articles. He ought, if his suspicion was aroused by anything that was called to his attention, to have gone to the directors and asked for an explanation.

Now, gentlemen, I am bound to say that I feel that the plaintiff has a perfect right to press upon you that the defendant's clerk (who, I think, was called Percy

Clark) was not called before you, because I am bound to tell you that the defendant is responsible for want of reasonable care by his clerks. This is a part of the work which cannot be done by the defendant only himself. Some of the work must be done by his clerk. He has said and gave his evidence most fairly, I think, whatever the consequence may be, 'looking back at it I can see nothing to blame my clerk for'. But you have to consider if either the defendant or his clerks through whom he was doing the work have failed to discharge their duty properly, or have been guilty of want of reasonable care; you must not press it too hard. I do not think Mr. Bankes used it at all unfairly, or pressed you too much upon it; for myself, it would have been more satisfactory if one had had some explanation as to what came to the knowledge of the clerk as to the cash in hand at the time. It is entirely for you, when you have considered what are the facts of this particular case, to exercise your own judgment as to that and take into consideration, because if you come to the conclusion that, *prima facie*, not sufficient inquiry having been made, the defendant has not put all the information he might before you, you are entitled to draw inferences from that from the absence of the clerk. Beyond that you ought not to go.

Now, gentlemen, Mr. Bankes, on the part of the plaintiffs, shapes his case in two ways. The first of them is that it is the duty of an auditor to check an asset such as is called and known as 'cash in hand'. Secondly, he says it is admitted that if circumstances of suspicion arise, the auditor ought to 'probe the thing to the bottom', and he says 'I (Mr. Bankes) suggest to you on behalf of the plaintiffs that there were grave circumstances of suspicion in this case'. It is entirely for you and not for me, but it seems to me in this case the first branch of Mr. Bankes' argument is the most important. Aye or no, were proper or sufficient steps taken to verify the cash in this instance? And, subject to your better judgment when I come to discuss the evidence as to the second branch of the case, I should have thought, if it was necessary to rely upon what Mr. Bankes called circumstances of suspicion, you would have much greater difficulty in dealing with the case. I now, for the purpose of the first question, will consider the evidence as to what may be called the *prima facie* duty of an auditor to verify an important asset, and I shall ask you presently as business men, to be good enough, as this is a very important case, to take the documents, and not simply accept my comments—to take the books—and you can find your way quite easily through them as business men. Now, I should have thought that is why this is the important proposition—that it could be scarcely disputed that it was the duty of an auditor to verify the cash in hand. How it ought to be done in a particular case is more difficult, but *prima facie* when a balance sheet is presented to an auditor it does not matter if the trial balance sheet should come to him or not, but I will take the trial balance sheet which undoubtedly did come to him. When the trial balance sheet of 1898 came to him, and he found among the items an item of £135 cash, and he found that it did mean cash somewhere that should have been vouched in some sort of way. Please understand, when you come to consider this case, if you think that is putting it too high, it is for you, and not for me; I only tell you how it strikes me as to the evidence. I think that may be made plain by taking the case of auditing the accounts of a large shop with several branches. Suppose in the interests of the shareholders it was necessary to know the cash in the till. Suppose there was a large establishment with branches at half a dozen places, the auditor auditing on various days, and there was said to be £500 in the various tills, made up of £50 in one place and £100 in another, and so on. I do not think anybody would dispute he ought to ascertain that the cash was there, and that is a way of stating the proposition which makes it plain on one side. On the other hand, when dealing with a business where money is being used by a particular branch, and one branch owes another so much money, it might be that the report upon a certificate of a qualified manager or secretary, or voucher of some sort of that kind, it would be amply sufficient justification to the auditor for passing the items.

The real difficulty in this case, as I think you will see on looking at the accounts and upon which I do not wish to express the slightest opinion, is aye or no, has Mr. Hasluck satisfied you in that respect he has discharged his duty? I put it rather upon him, because I think it ought to be taken, and he does not really dispute it, that he has got to vouch and be satisfied with the correctness of the

items in the balance sheet. That being so, has he done it sufficiently? Now, here comes the difficulty. It has been suggested as though the preparation of these things depended in the first instance on Mr. Hasluck. That is why I think Mr. Bankes may have pressed too much the question of the mere amount of cash supposed to be out. Now, the first that he gets is a trial balance sheet of 1898, and that contains the five items at which you ought to look: the cash at Melhuish's, that is one of the wharves—I have marked them, gentlemen, in blue, so that you will see them in each year—£14 one wharf, £8 another wharf, £15 another wharf, and £133 the city office. Now, it is very difficult to express any view upon this without apparently indicating more to a jury than one ought, but take the question of the small item of cash supposed to be at the three separate wharves—£14, £8 and £15. In order to test that being there the man ought to have gone to the wharves and seen the money or had it brought to him or, it may be, some voucher given to him. Mr. Bankes does not complain in this action directly of those three amounts which form part of the total sum in hand, which in that year was £171 10s.; he does not complain of those three items not being examined; what he does complain of is that there is no evidence before you of £133, which is the balance, ascertained by taking the petty cash and subtracting the credit side from the debit side, that the city office owed to the business. I shall ask you to look at that account, and to see whether you come to the conclusion that under all the circumstances of this case it did show a want of reasonable care on the part of Mr. Hasluck and his clerk not to have investigated whether that £133 was really there. I postpone speaking of that particular year, and saying that it ought to have attracted suspicion, because it had gone from £21 to £133, as that relates to the part of the case dealing with the question of there being circumstances of suspicion. Then you come to 1899. In the same way you will find there are four items there, the total amount being altogether somewhere about £500, or very nearly £500. I think £479 of that is due to the city office—that is to say, it is item 748. If you turn back to the item 748 you will find there the city office received so many hundreds or thousands of pounds, and £479 was due to the office. You have to ask yourselves, under the circumstances of this particular case, was the auditor whose duty it is to be satisfied that that is a true asset entitled to do no more than this gentleman admits that he did—namely, verify that the secretary had acknowledged the receipt from the company of, we will say, £2,000 or £3,000, which represented the gross receipt in that twelve months' expenditure—£1,900, or whatever it was on the other side? and admitting that the office owed the business that amount, if you think he did enough there would be no question of breach of duty as to that. If you think that, looking at this quite apart from the question of there being big and small items, a reasonably prudent accountant would not have let that item pass without saying the £479 was somewhere, and where it was, you will have to express your opinion whether there was a breach of duty on the part of the defendant in that respect or not. I need not take you through the other items. I have marked them in blue, and I ask you to look at them in the trial sheets, because you have to make up your minds and be satisfied that the defendant discharged his duty in ascertaining that the cash balance was somewhere available, upon such evidence before him that you—as reasonable men—think he did enough. I do not want to repeat it. I am sure you understand me. He had before him original and genuine entries not challenged, showing the office had received in one twelve months £2,600, that they had spent a sum of £2,000, and that the head office therefore owed the business £600. He does not allege that he asked for more than seeing and checking that those were truthful business entries. If you think that in such a business so conducted it was his duty to ascertain that the cash was there, quite apart from circumstances of suspicion, of course you will not hesitate to say so.

Now, gentlemen, that is the part of the case so far as it depends upon the *prima facie* duty of the auditor to verify the asset. **It cannot be disputed that when an auditor returns to the shareholders an entry of cash in hand he must have taken reasonable steps to ascertain that the cash was in hand. That does not enable you to answer the question without considering what he has done, because there may be cases in which he would be justified in acting on the representation of a cashier, or a servant whom he**

had no reason to distrust; and, on the other hand, there may be cases when he ought to go further and examine. You will have to say when you come to consider the matter, within which of those categories this case falls.

Now I come to the question of the circumstances of suspicion, and, though I express an opinion with the greatest diffidence, it seems to me that the case for the plaintiffs is not so strong as it may be put with reference to the non-verifying. It is said, 'You, the auditor, ought to have known that for a man to have these increasing balances due from the city office to the business was something suspicious'. Now, on the mere question of amount, there was one fact mentioned that I think ought to be mentioned in the defendant's favour. Mr. Bankes says when it jumped in 1898 from £21 to £133 that ought to have aroused suspicion. It had been up to £136 three years before, and the mere question of amount therefore would not seem to me to be of importance, but you have to consider for yourselves, is the fact it had got to £133, and the next year went to £479, to be considered or called by the auditor and his clerks a suspicious circumstance? Now, gentlemen, here I do not think it is at all unfair to the plaintiffs to say it may be pressed too hardly against the auditor. I think to this extent he is within the authorities and the ruling laid down by the Court of Appeal that he is not bound to criticise the policy of the directors, and if he finds for a series of years larger amounts have been left in the hands of the cashier than at first sight would seem to be required I do not think there is any *prima facie* duty upon him to inquire into that. It is a matter of policy and not of audit. If it becomes suspicious, then you will understand that different considerations arise. But I confess, on the mere question of holding a larger amount, that that seems to me to have been pressed rather too far. Mr. Bankes called it, you know, 'petty cash', but that is not quite the way I think you as city men will regard it. The items were arrived at by including the lighterage wages and the petty cash in the cheque. It is perfectly true that the smaller portion of this cheque was made up by the petty cash, but the lighterage charges went through this same head office account, and they did amount to as much as £50 or £60 a week, and it is not right to speak of it as a demand for petty cash only; but there is the fact, he had several hundred pounds more than was wanted for the larger expenditure he had to make, and I cannot do better than indicate to you what Mr. Bankes brought out in evidence to-day, which puts it very clearly in the six months up to the middle of October, 1898, having had a balance of £133 on the 1st of May, he drew £1,585 and spent £1,300—that is to say, he would have increased his balance during the six months by about £300. Then in the next six months he drew £1,245, and spent £1,050 which would have increased it by £245. Gentlemen, it seems to me fair to say that, apart from any circumstances that aroused suspicion, the fact that the directors, who must be assumed to know something of the business from week to week, let this amount of money remain would be a circumstance of itself. An auditor ought not to act blindly; but still, he ought to take it into his consideration. It seems to me difficult to say it was a circumstance of suspicion. If the retention of a large balance by the city office did not arouse the suspicion of the directors, it does seem rather hard to say that it ought to have aroused the suspicion of the auditor. You will understand that I do not put this as taking away from his duty to examine the cash balance. I only deal with it as a circumstance of suspicion. There are five periods when the directors must have known of it, and that must not be lost sight of, that is when the balance sheet came out. I shall have to refer to the lumping together of the cash in hand and bank balances, but there are four periods when it is the duty of the directors to apply their minds as to how the business is being conducted, and that is the £133 in 1898, the £574 in April, 1899.

Mr. Bankes: That is when it is lumped, my lord.

The Lord Chief Justice: I will refer to it in a moment, £479 in April, 1899, £624 in 1900, £625 in 1901, and £681 in 1902.

Mr. Bankes: Not in any account that came before the directors, my lord.

The Lord Chief Justice: I assure you that I have not forgotten it, and I am doing my utmost to state it fairly. I do not say which 'came before the directors'. I avoided that because I was coming to it. I said 'in the accounts of the company'. The account I have is the trial balance sheet, and the books of the company. I dare say it did not come before the directors.

Now Mr. Bankes says it was a suspicious circumstance that in the year 1899 it was lumped with the banker's balance, and that ought to have aroused the suspicion of the auditor. It is very easy to be wise after the event, but unless the fact that there was so much cash in hand, which undoubtedly did come to the knowledge of the auditor, was in itself a suspicious thing (and that is entirely for you), why its appearing in one item can be thought to increase the suspicion I have a difficulty to understand. In the trial balance sheet sent to the auditor it is not lumped at all, but treated as a separate item. It is true, in the final balance sheet, and I dare say in the draft that went before the directors, it is lumped, but, as the directors told us the bank pass books were before them at every meeting, it is entirely for you—do not take my judgment. If you should be of opinion there was nothing suspicious in the fact that there was this comparatively large balance in the hands of the cashier it will be for you to say if the fact that he lumped it in the final balance sheet—after having told the auditor the details of it—was, of itself, a circumstance to arouse the auditor's suspicion. Mr. Bankes presses you to say the directors may have known nothing except what appeared in the rough balance sheet which came before them, or the final balance sheet which the auditor signed. Whatever be the fact as to that, it is entirely for you. The substantial matter would seem to me to be, aye or no, whether this circumstance of the large balance was enough to arouse the suspicions of the auditor.

Now, gentlemen, I come to the other part of the case, on which the absence of the clerk does present a very great difficulty. You may be of opinion that some inquiry should have been made with regard to where this cash was: that the mere fact that when you are dealing with a company of which the profit and loss or the turnover is about £21,000 a year, and the total paid-up capital is only £47,000, that an item such as several hundred pounds 'cash at bankers' is enough to require a proper examination. Of course, the real difficulty that you are in here is that we do not know what did pass between the clerk, Mr. Hasluck's representative, and Mr. Frederick Clarke, the fraudulent cashier. Of course, if Mr. Clark, Mr. Hasluck's representative, asked where that balance was, and was given a satisfactory explanation, either by the money being forthcoming or by a statement which an honest man may have believed, a very different consideration would arise; but for reasons which we do not know, and we are not entitled to speculate more, except that Mr. Bankes is entitled to say it was the duty of the defendant to put all he could before you, as to what explanation could be given to you by the clerk, and I am bound to tell you that if Mr. Frederick Clarke gave to Mr. Hasluck's representative an explanation which was not satisfactory, and which ought to have aroused Mr. Hasluck's clerk's suspicions, Mr. Hasluck is responsible. That is a part of the case which, unfortunately, is left in the dark. We do not know. Mr. Hasluck cannot say, 'I never saw that cash book myself, but I am sure I saw the entry of £133 and £479 and £624, because they are on these papers that I have ticked'. But whether or not he was acting on a vouching by his clerk which was not satisfactory we do not know. It is entirely for you. I tell you it is the prima facie duty of Mr. Hasluck to satisfy you that he has properly fulfilled his duty of seeing that that asset was there, and it will be for you to say whether or not he has discharged his duty in that respect. The final certificate he gave is this. He first, in accordance with the Act, certifies that all their requirements as auditors have been complied with. Whatever that is, he made inquiries of the directors and they concealed nothing from him. 'We have audited the above balance sheet, and in our opinion such balance sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as shown by the books of the company.' That does not mean in any way to discharge Mr. Hasluck of the responsibility of ascertaining whether an asset put down did in fact exist, and, as Mr. Bankes put to you, **he has the same duty to discharge in regard to the verification of the cash as he has with regard to the verification of the securities.** However, gentlemen, to state the proposition is one thing, and to answer it is another, and I am very glad that the responsibility of answering it rests with you and not with me.

Now I have said, I think, all I think necessary to make it clear on the question I shall leave. Was the defendant, or were his clerks, guilty of any breach of duty or any want of reasonable care in the conduct of their duty in the years 1900,

1901, 1902, or 1903, or, if so, in which of them? I tell you the auditor is bound to take reasonable steps to see that any such important item as this is not inserted in the balance sheet without warranty, but what is the degree of the inquiry he ought to make must depend on the particular circumstances of the case. You will see the accounts and what was before him. While I tell you, on the one hand, he is not bound to suspect Mr. Frederick Clarke as being a dishonest man, he is entitled to rely upon the fact that he is the trusted official, and has known him for years, but that does not justify him not using reasonable precautions; he is not entitled to let his duty be performed on the credit of Mr. Frederick Clarke rather than perform his own duty upon his own responsibility. If you thought there was a breach of duty in one of those years, you would have an extremely difficult question to answer, and that is the damage caused. It may be a very substantial sum, of course, it cannot be more than £766, because that is the total amount of the loss; indeed, it cannot be as much as that, because I point out the auditor does not guarantee the honesty of the employees. He could not do it, and, as Mr. Bankes properly put to you, if he ought to have found this out in 1898, as Mr. Bankes suggests, £133 *ex hypothesi* would then have gone, and that is the amount he suggested to you was not then forthcoming. If you take the view that that is not enough to show any want of reasonable care, the next year it had risen to £479, and if that £479 (I will take care that you have all these figures before you) had been by that time practically lost, Mr. Hasluck is not responsible for that. He is responsible for whatever damage you think has been occasioned by his not properly auditing the books.

Now to come to the really difficult question whether or not this money had substantially disappeared by the end of 1900. The only evidence we have got is the evidence of Mr. Hubble, and I quite agree with Mr. Bankes that he gave his evidence extremely fairly, as I think all the people in this case have done, notwithstanding the difference of position of some of them. Mr. Hubble does not say that he examined that cash box. There is a great deal that has been said on both sides, and I do not want to repeat what has been said by counsel on one side and the other most ably, but I think Mr. Isaacs gave you reasons for thinking that he asked for the amount without looking at it, and remembering that Frederick Clarke was a secretive character, it may be that that cash box was not examined; but Mr. Hubble does say, 'I certainly should not have made a requisition without seeing what cash I had in hand, because, though I knew what I wanted from the lightermen's estimate and from the wharf's estimate, there was something still I wanted—namely, £20 or £25, as the case may be, and I should not have asked for it without knowing what it was.' He asked for three cheques—£85, £75 and £80. Gentlemen, you have to look, and I shall ask you to look, at that particular month, because I think, in justice to Mr. Hasluck, it ought to have been put. It is perfectly true that Mr. Hubble said he does not think all the credit entries in that year were entered up; he thinks some were, but naturally he cannot say what were entered up. If you look through that book there were very large balances indeed standing to the credit of this account all through that period from April, 1900, to December, 1900. If the book was at all made up at that time I can scarcely imagine Mr. Hubble's attention not being called to it—that there was no less than £802 on the debit side and only £161 on the credit side, and at that time there was a balance due of something like between £500 and £600. If the book was not made up, and he had only to enter, as he did enter, the expenses as he paid them out, it would not convey the same indication to him as it does to us now. This is the difficulty of judging a case after the event. It is fair to Mr. Hasluck to say the condition of the book, whether it was at that time either not entered up, or, if entered up, showing a large balance in the hands of the cashier, does not appear to have excited the suspicion of Mr. Hubble at all. He made no representation to his directors; he makes a request for very large cheques. It is a requisition on the 14th December, £215; on the 21st December, £347; and on the 28th December, £200. Therefore he makes very large requisitions, and it is only fair to say, if the book was made up, that must have shown a very large balance in the hands of Mr. Frederick Clarke; and if the book was not made up, it would be a circumstance that Mr. Hubble would have called the attention of the directors to, but it does not appear to have excited his suspicions. You have this difficulty; Mr. Bankes suggests

to you that practically the greater part of the money had gone by 1900, and that therefore, at any rate after that time, £400 or £500 would have gone, there would not have been the further loss of £200 or £250; and I think you are entitled to take this view if he ought to have found out that there was this large sum supposed to be standing to the credit, which would have called the directors' attention to it if the auditor remarked upon it; then, though they would have lost that £400, they would not have lost the further sum, and the damages recoverable from this defendant would be something like £250. You have to consider, aye or no, did this failure of the auditor to disclose it really cause the damage or not? You have to be satisfied that it was the result of the breach of duty. We do not know, unfortunately, what this man's condition was; whether he was in money at one time of the year, and whether speculating or possessed of money we know nothing about. The plaintiffs must satisfy you that the damage has been occasioned, to whatever extent you think it was occasioned, by the breach of duty on the part of the auditor. If, although it was a breach of duty, this loss would have been sustained unless the man had stolen the money after the breach of duty was committed, of course you will find there was no substantial damage by this breach of duty. The action is for breach of duty, and the damage is nominal damages. I cannot give you much more assistance. I wish I could. On the one hand, it is said that £450 had gone by the end of 1900. If so, the damage would be somewhere about £300. If Mr. Isaacs is right in suggesting to you that the money may have been there on the 30th April, 1902—not a very likely suggestion in view of what we know about the man, and the speculation was that the loss was due to improper conduct by this man, who was trusted and receiving large sums of money—whatever your views may be of the conduct of the defendant, you ought not to make him pay the damages, if he is not responsible. **The conduct of the directors is no answer to any breach of duty by the defendant, but it is a circumstance you must take into consideration, because if you are of opinion that the loss was occasioned by a man stealing the money in consequence of there being a want of proper control over him, then the fact of there being a breach of duty by the auditor is what we lawyers call a *causa causans*, which contributed to, but would not be the cause of the loss. I do not know that I ever remember a question the solution of which was more difficult in the concrete. It is easy to put it in general terms: Was he guilty of breach of duty, and, if so, what loss was occasioned to this company by that breach of duty? You must not put upon him the loss by reason of theft occurring afterwards or before, but you must put upon him such damages as you consider in your opinion were really caused by his not having fulfilled his duty as auditor of the company.**

Now, gentlemen, I have endeavoured to put these questions clearly, and I will give you the papers in such a way that you can follow them, and then ask you to answer the questions. *That* is the list of balances; *there* are the trial balance sheets; *that* is the actual balance sheet; and *this* is the demand that is made for the money each time. You will find the index number against each item, and you will have no difficulty in tracing them.

The jury retired at 2.53.

The Lord Chief Justice: I do not refer to these conversations—the question about looking beyond one's nose and so on, because I thought they were so unimportant—but if you wish me to direct the jury upon them I will. The other is much more important.

Mr. Bankes: I am quite content, my lord.

The jury returned into Court at 3.55. The foreman having handed up a paper to his lordship.

The Associate: Gentlemen, are you all agreed?

The Foreman: Yes.

The Lord Chief Justice: As to the first, the jury say that there was a breach of duty in 1899, 1900, 1901 and 1902, and that there was damage to the extent of £5 5s. 0d. The jury add that they consider the directors have been guilty of gross negligence.

The jury was then discharged.

The Lord Chief Justice: I think this had better be mentioned to me to-morrow

morning by Mr. Banks and Mr. Isaacs. I think it is better that it should be so, as they may have something to say—that is, mentioned either to-morrow morning or at any time convenient to Mr. Isaacs or Mr. Banks.

Mr. Wallace: If your lordship pleases.

JUDGMENT

THE LORD CHIEF JUSTICE: As this case may go further, and I think it is a very important case, I should like to say in a few sentences why I cannot enter judgment for the defendant, and then I will deal with the question of costs.

There were two grave issues raised in this case. First, had there been a breach of duty or not? By 'breach of duty' I mean a breach of contract. Had there been a breach of contract by the auditor or his clerks? Mr. Hasluck, who is obviously a most honourable and straightforward man, elected to fight the case upon the basis that there had been no breach of duty. I was asked at the end of the plaintiffs' case to stop the case, but I felt that there was some evidence, especially as Mr. Banks raised the point of there being circumstances which should have aroused the auditor's suspicions, as to which I think there was no substantial evidence of any sort or kind, but still there was some evidence, and I could not stop the case. The defendant, in the course of his case, did not call the clerk by whom the audit had been conducted, and it seems to me under the circumstances, if my ruling was right as to the duty of the auditor, it was quite open to the jury to find that they were not satisfied that there had been sufficient inquiry with regard to that particular asset in those four years, and I would call attention to the fact that the jury have, I think rightly, limited their finding to the years 1889, 1900, 1901 and 1902, when the asset was a substantial sum of money not less than £470 in the first year. I think that there was a very substantial question of principle to be fought. It was not a case in which Mr. Hasluck had said (as he might have said quite honourably, I think): 'My clerk was careless, but the directors so acted that it caused the company no damage.' If that had been the way the case had been fought, I think Mr. Isaac's contention would have been unanswerable, and that the action ought not to have been brought. I am bound to say I think that there was a very grave and substantial question to be fought and tried, which the jury have answered, in my opinion, absolutely rightly, that there was not a sufficient fulfilment of his duty in ascertaining whether that asset really existed. I particularly desire to avoid using the words 'counting the cash'. I do not think it is the true statement of the duty of an auditor, although it is one way of putting it. Anything may be 'counting cash', if you ascertain it is there; but, as I tried to point out to the jury, there may be cases in which the actual counting of the sovereigns is not even the best way of vouching or ascertaining the amount. Therefore I think the jury did take the view properly that there was not a proper discharge of his duty by his clerk—nothing morally wrong in the least, but not a sufficiently careful supervision by Mr. Hasluck's clerk of the asset which was believed to exist, and which was shown by the books to exist, because that the audit was most carefully performed I have not a shadow of doubt apart from this. I think there was a substantial issue properly raised by the plaintiff, and properly defended by Mr. Hasluck, if he determined to fight the battle on the ground that he did fight it, that there was no duty on an auditor to ascertain the existence of an asset, assuming the books showed that that asset ought to have been in existence. Therefore I think a substantial question had to be tried, and that entirely makes it impossible for me to say that there was not an issue before the jury as to breach of duty, and, if it was a breach of duty, at any rate there must be nominal damages.

Then Mr. Isaacs says because the jury have said the large damages found in the claim of the plaintiffs were not the result of that breach of duty (in which I absolutely and entirely agree) he ought to have judgment for the defendant. I only point out that that would have been a perfectly good argument had the defendant come into Court and said, 'I do think my clerk was not sufficiently careful and did not sufficiently perform his duty, but no damage was caused to the plaintiffs'. I do not think the defendant is entitled to have that issue tried and fought (and I need hardly say it was most ably fought) for the best part of two days at the plaintiffs' expense.

Then as to the costs, I confess I have very great doubt. In an ordinary case I

do not think the rule Mr. Isaacs indicated of letting the law take its course is a very good one in actions of tort and libel, and cases of that kind. I think there was a substantial question to be fought here, and that the finding of the jury that the directors have been guilty of gross negligence, though a perfectly proper finding in order to show why they come to the conclusion that it was not the breach of duty which they had previously found that caused this large loss, ought not to affect the question of costs with regard to the trial of an issue of such very great importance to the parties, and in one sense probably important to the the public, though I do not think that is important here, but it is a case in which Mr. Hasluck represents a great profession, and I therefore think that I ought to say this is a proper case to have been brought in the High Court, or whatever the form is.

SMITH v. SHEARD*

(Decided before BRAY, J., and a Special Jury, at the Liverpool Assizes, on 9th 10th and 11th May, 1906)

Liability of accountant—Audit at request of creditors—Defalcation by employee—Claim for damages—Partial audit

An action was brought by Mary Ann Smith, married woman, carrying on business as a manufacturing stationer in Liverpool under the style of Dickinson & Co., for damages for neglect in the audit of her books, against Theodore S. Sheard, accountant.

Mr. Rutledge stated that the plaintiff claimed damages for neglect and carelessness in the audit of her books, by means of which she incurred heavy losses consequent on frauds. The defendant denied that he was the auditor of her books, and that she sustained any loss through neglect on his part, and also that, if there was neglect, the plaintiff was guilty of contributory negligence; while, further, the defendant counterclaimed for certain sums for work done, which plaintiff denied.

Mr. Shee, in his opening, stated that the allegation of neglect was that in consequence of the inefficient auditing of the books by the defendant, the late cashier of the plaintiff embezzled certain sums of money, amounting in all to about £700. Plaintiff had been in partnership with Mr. Dickinson, but on account of the latter overdrawing more than he was entitled to this partnership was dissolved in 1902, and a consultation with the creditors was decided upon. Mrs. Smith then found that Mr. Sheard had been acting as auditor to the firm, and she intimated that his services would be continued in this capacity. As a matter of fact, it was alleged that he not only undertook the auditing, but her affairs in regard to the creditors and the collection of debts. In December, 1902, the plaintiff's cashier, who had since been prosecuted and who was now dead, began to make fictitious entries in the books and appropriate money from the business. When defendant audited the books and prepared a balance sheet in 1904 he made a charge of forty guineas, to which plaintiff demurred, remarking that she did not think the work had been done properly. Mr. Sheard replied that the consequences of such a statement would be very serious for one of them. The defalcations of the cashier were not discovered until April, 1905, and it was contended that if the audit had been an efficient and proper one the misappropriations would have been found out much earlier, and the losses thus prevented.

Evidence was given in support of counsel's statement by the plaintiff.

Cross-examined by Mr. Horridge, witness stated that in order to save expense, and because of the confidence she reposed in the cashier, she did not instruct the defendant to audit her books in the way he had done in the time of Mr. Dickinson, and that consequently the bank book, cash book and vouchers were not examined for eighteen months.

Miss Amery, in explaining the system of book-keeping at the plaintiff's office, stated that the defaulting cashier collected accounts outside and gave receipts from a counterfoil receipt book, which she was unable to say was asked for by the defendant's representatives.

Cross-examined, witness said that everything was left by Mrs. Smith to the

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cashier. As far as she knew, Mr. Sheard never had the counterfoil book, the rough cash book, or the vouchers.

Walter Appleton, of London, representing a firm of creditors, stated that at a meeting of the creditors when Mrs. Smith took over the business it was agreed to give the plaintiff time to pay the debts on condition that Mr. Fosbrooke, the defendant's partner, took entire control.

Arthur Whittaker, chartered accountant, Manchester, deposed as to the state of plaintiff's account books and the evidences of the partial audit which they bore. The question of what an audit was was a difficult one, but a generally accepted opinion was that it meant a comprehensive investigation of the books for the verification of the entries in order to arrive at a proper statement of the position of the client. He did not think there was any difference between an audit and a 'complete audit', and without some understanding to the contrary an auditor must audit all the books. He maintained that the entries from the rough cash book into the general cash book, and from the original carbon counterfoils to the summary book, had not been checked as they should have been. Vouchers also should be asked for by an auditor.

Mr. Horridge said he did not dispute witness's evidence as to non-checking, the whole point being as to what were the terms of defendant's employment.

The question of amount, it was agreed between the parties, should be reserved for the present.

Witness, proceeding, stated that if vouchers had been asked for, fictitious entries would have been discovered in the cash and purchase invoice books.

Cross-examined by Mr. Horridge, witness stated that his evidence had been given on the assumption that the defendant was employed to give an audit in the strict sense of the term. It was apparent in this case from the books that the defendant had not purported to audit in such a manner as to check the honesty of the servants. It was usual for an auditor to certify the accounts as 'audited and found correct'. Mr. Sheard had not done this. There was no necessity to ask for the counterfoils of receipts for the purpose of posting the books and preparing a balance sheet only.

Two other witnesses were called for the plaintiff, whose case was then concluded.

Mr. Horridge, for the defence, argued that from the very first Mr. Sheard had taken up the position that he was never engaged to audit, and that he had never for one moment pretended to do so. He had only done the work of checking the books and making out a balance sheet in a way that was the custom amongst private firms. It was not intended to audit the books to check the accuracy of the entries or the honesty of the servants, but simply to take out a balance sheet which correctly represented the books. That was shown by the very fact that the defendant had never asked for vouchers and counterfoils. The arrangement when the partnership between Mrs. Smith and Mr. Dickinson was dissolved was that the books should be put on a proper system of double-entry, and balanced half-yearly. Mrs. Smith did not want her cashier checked, as she reposed the fullest confidence in him. He maintained that if the word 'audit' had not crept loosely into a bill that action would never have been heard of. Mrs. Smith had constantly stated that she wished to save expense, and she intimated that it was only necessary to do sufficient to satisfy the creditors by putting the books on a better system and furnishing a balance sheet. Counsel proceeded to quote letters bearing on Mr. Sheard's engagement, and submitted that every document and inference was in favour of the defendant. The secret of that case was that Mrs. Smith had lost her money through her late cashier, and that she never made a bargain with Sheard to audit at all. The balance sheets were not signed or certified for the simple reason that an audit had not been made or had been intended to be made.

Mr. T. S. Sheard, the defendant, gave evidence. He said he had carried on business in Liverpool as a chartered accountant for twenty years. He emphatically denied that he had ever agreed to make a complete audit of the plaintiff's books or anything to that effect. If he audit accounts or balance sheets he usually gave a special certificate stating what he had done. If he was only instructed to take out a balance sheet he took the figures as stated in the books, and did not sign it.

Cross-examined, witness disputed that there was any discussion between himself and Mrs. Smith about it being a serious thing for her if her statement about his

work were false. He was astonished when he was blamed for the non-discovery of the defalcations.

John D. Fosbrooke, defendant's partner, stated that in consequence of Mrs. Smith's anxiety to save expense until the creditors had been paid off, the arrangement was that he should only check the posting in order to enable him to balance. He denied that he had told Mrs. Smith that he had made a 'complete audit' of her books. The word 'audit' had been put into the bill of charges by a clerk, and it should have been 'auditing of postings'. He did not ask for vouchers, because he was not making a thorough audit of the books.

Cross-examined by Mr. Shee, witness stated that it might have been less trouble if he had let the cashier do the posting, and if he (witness) had applied himself to checking the cashier's honesty, but witness was stopped by Mrs. Smith from doing that.

Mr. Sidney S. Dawson and Mr. W. C. Spencer, chartered accountants, deposed that it was the practice after making a thorough audit to sign the balance sheet or give a certificate. In this case, Mr. Spencer said, there was no evidence of vouchers, &c., having been checked. The work done by the defendant was not valueless, but was necessary for balancing purposes, and in the absence of fraud would have shown the assets, liabilities, capital, profits and drawings of the partners.

In answer to Mr. Shee, witness said that the defendant's audit would be valueless for the purpose of detecting fraud.

Counsel having addressed the jury,

Mr. Justice BRAY, in summing up, said: Gentlemen of the jury, I may have to occupy your time for a little in going into this matter, which is a very important matter. It is important for both parties; it is important for the plaintiff because she says that Mr. Shand has defrauded her of some £700, and that if the defendants had done their duty Mr. Shand would have been detected long before all that money was lost and she never would have lost the money. £700, of course, is an important sum. On the other hand, it is equally important for the defendant—not more important, but equally important for the defendant—not only because the sum is a very considerable sum, but because he is charged with having entered into a contract which he never performed or attempted to perform—that is the charge against him. It is a serious charge against professional men, and when Mr. Shee talks to you about disregarding the question of onus of proof, and asks you to look upon it as a matter of common sense, I ask you to look upon it as a matter of common sense. First of all, at law common sense and law usually agree, but it is law that the plaintiff must make out a contract, and a breach of that contract before she can succeed. But it is common sense too. One of you gentlemen some day might be sued by somebody setting up some verbal contract which you have never entered into, and you would think if an action were being brought against you—would not you think it was fair that when there are no documents proving what the contract was, if there are no documents it is a case that should be proved against you fully? Now the law says that, and common sense tells you the same. Now, gentlemen, as I have told you, this is an action for breach of contract, and it is admitted that the whole question turns upon what was the contract, and therefore the simple question that I am going to leave to you is this: Did the defendants agree with the plaintiff to make her a complete audit? Is that what they agreed to do? That is what the plaintiff has got to prove to you, because it is common ground that if that was their contract they never performed it or attempted to perform it; because it is common ground again that a complete audit means having every item vouched for and every entry—every book brought up and every item vouched for—and, of course, it is common ground again that if every item had been asked to be vouched for and every book had been examined the defalcations would have been discovered; they must have been discovered. Therefore that is the question that you have got to try. Has the plaintiff proved to your satisfaction that the defendants agreed to make a complete audit? Now it is purely a question for you; it is not for me, it is for you; and any observations that I may make, except when I am dealing with a question of law, are observations which you can give just as much or as little weight to as you choose.

Now I am bound to say that the first observation which occurs to me is this: It does seem to me a remarkable thing that if these people really did agree to make a complete audit that they should not have done it. It was to their interest

to do it. There was no bargain as to price, and the more time they had to spend upon these books the more remuneration they would get, and you, gentlemen, know, of course, there is a profit upon every hour's charge that they make, and it was to their interest—to their profit—that they should make as complete an audit as possible, because that would take more hours and would mean more profit, and it does occur to me that that wants explanation, why the defendants if they had agreed to make this complete audit never did so. Now, gentlemen, that is an observation on the law; it is simply an observation that you will take notice of. Now, as I told you, the plaintiff has got to prove her contract. The contract, whatever it was, was clearly made about the beginning of 1903; that is common ground. Whether it was in December or January does not much matter; the defendants put it in January; the plaintiff does not give any actual time herself, except that it was about that time. Now first of all you have got to see what did the plaintiff say herself, and you have got to ask yourselves, is that true? If it is true, what does it mean? Or if it is not true, what was the contract? Now this is what she said: 'Fosbrooke was Sheard's general manager, and he asked me what I was going to do about the audit. I told him I was going to make no change in anything.' Now that is her own story, mind you, the story that she repeated more than once, which means, if one can understand it, it means you are to go on doing the work which you did before. Then she says: 'I told him I was not going to make any change in anything and knowing I had no knowledge of books I expected them to do all my books. I am not sure of the words I used. I said I hoped they would take special care, knowing that I knew nothing about books, and I was making no change at all. Fosbrooke told me he was going to take special care about the books, and he should want to make a few alterations. Mr. Shand was my head man; he was called in, and I told him to give every assistance to Mr. Fosbrooke.' Now she is cross-examined, and Mr. Horridge wanted to see whether he was quite clear that he understood the contract—that according to her version they were to do what they had been doing before. The employment was the same, but they were to take more care. What I do not understand—the employment was continuous—they were to audit the books in Dickinson's time, but they told me they could not get at them. Now, gentlemen, of course that is her story.

Now let us see what the contract was that was made. You have got to look at what had happened before, and therefore it is most vital to see what was the work they had been employed to do before. Now I must go right through that with you, but there cannot be a shadow of doubt, although it is for you to say that they were never employed to audit the books before and never did so. Now you will see. You know bills were sent in. According to Mr. Fosbrooke these bills were brought to the plaintiff—to Mrs. Smith—when she was making the arrangements for going on with the work at the time this contract was made in January, 1903. Now the correspondence shows this, that the first time these defendants were employed by the firm of Dickinson & Co. was about March, 1900, and they were employed for this reason. Mr. Dickinson—I suppose their position perhaps was a little critical—Mr. Dickinson wanted to know first of all what were the total annual sales; he wanted, secondly, the balance sheet made up to the end of the 31st January, 1898, so as to show what was the position between them as to capital. Apparently their arrangements were more or less vague as to capital, and they wanted to commence and see how much capital Mr. Dickinson had got in the business, and how much Mrs. Smith had got in it. That was the object with which they were employed. Now you get from the documents and from Mr. Sheard's evidence—not denied by Mrs. Smith—the common question. Now Mrs. Smith tells you, 'Oh, I knew nothing of what was going on in Dickinson's time'. Now we shall see that is not quite correct. She knew; she wanted to know as much as Mr. Dickinson where they were as to capital.

Now we will see from the bills that were sent in what they were doing. Now, gentlemen, I will hand in the bills to you, so that you may follow them. The first one is not here. I will give it you presently. '28th May, 1901. For services rendered preparing schedule showing the total sales of your business from April, 1898 to April, 1900.' You won't find that one here; I will hand it to you. 'Preparing balance sheets at 31st December, 1898, and 31st March, 1900, and profit and loss account for the eighteen months ending 31st March, 1900, £42.' Now you take

that. Now I have read it to you it is perfectly clear from that that there was no audit; there is no pretence for saying that there was anything in the nature of an audit. Now the next is this. You have got the next one yourselves. It is No. 2. You will find these later ones are all misleading—the 31st January, 1903—because they were not delivered until that time. '31st January, 1903.—For services examining and balancing your cash book for the year ended 31st March, 1901.' Now again it is agreed that is not audit. Mr. Shee does not suggest that is audit. 'Checking ledger balances and preparing balance sheet at that date. Attending numerous interviews with Mr. Dickinson and Mrs. Smith, discussing affairs, and reporting as to cash drawings monthly, fifteen guineas.' You know Mr. Sheard says it is quite plain from the correspondence that they discovered when they got out these balance sheets that Mr. Dickinson was apparently overdrawing, or drawing more than he should do, and was making the capital too small, and the result of what took place appears from a letter of May the 1st, 1901, and that is a letter from Mr. Sheard after he had seen Mr. Dickinson and Mrs. Smith. 'In confirmation of my interview with Mr. Dickinson and Mrs. Smith on Monday morning, I beg to recapitulate the arrangements that were then come to.' Now you know Mrs. Smith talks a little about her knowing nothing of what was going on. She and Mr. Dickinson had met and had arranged what should be done. '(1) The balance sheet as at 31st December, 1898, is to be taken as a basis of the partnership agreement, in accordance with which the capital therein shown is to be apportioned two-thirds to Mr. Dickinson and one-third to Mrs. Smith.' Then Mr. Sheard had written some five days before that pointing out quite clearly that that balance sheet did not profess to be an audited balance sheet. The parties agreed that that should be so. '(2) Balance sheet made out as at 31st March, 1900, and the profit thereby shown for the previous fifteen months is also to be taken as correct. I am to proceed.' Now this is what he had to do: 'As quickly as possible to prepare a balance sheet as at 31st March, 1901, and on the completion of same a further meeting will be held, when it will be decided whether such balance sheet should be adopted as correct. (3) From the 31st March, 1901, the books are to be placed upon a proper system of double entry and balanced half-yearly. In future a rough cash book is to be kept, into which are to be entered full particulars of all payments and receipts and the balance in hand is to be paid into the bank daily. With a view to carrying out the foregoing arrangements Mr. Fosbrooke yesterday interviewed Mr. Shand and discussed the future book-keeping. I find several alterations in the system of book-keeping will be necessary, as many of the present methods might be improved upon.' There is something about purchases, about sales, about allowances and returns, and about ledgers, and so on. I need not read that all to you. It points out the alterations that Mr. Sheard is going to instruct Mr. Shand to carry out so that the books may be properly entered up with double entry, so that he may be able to make balance sheets.

Now the next thing that happens is this: There was a number of accounts owing, it being found that Mr. Dickinson was drawing all the money from Mrs. Smith's balance. There was sent an account of the drawings—the monthly drawings—and this is the form of that: 'Dear Sir,—I beg to report that I have examined your cash book for the months of June and July, and that I find the drawings are as follows: Mr. Dickinson so much, Mrs. Smith so much. I have also to report that the following cheques appear in the bank book, but are not entered in the cash book, and that a corresponding number of counterfoils in the cheque book are blank.' Then follows a list of these items, and 'Please let me know to what account these are to be debited, and oblige.' Now that was the usual form and that went on until September—about the middle of September, 1902—when Mr. Dickinson left the office and then the question arose: What was to be done? Mrs. Smith took the advice of a solicitor. She took advice, and the advice was to get rid of Mr. Dickinson, and accordingly that was done.

Then, unfortunately, there were creditors who were pressing. What was to be done? The creditors had to be asked for time. The principal creditors were asked for time, and the proposal was that they should take bills for four, eight and twelve months, so as to give Mrs. Smith time to turn round. Now we follow the accounts. The accounts say what work was done with reference to that. The next one we have got is 1901 to 1902. That is No. 3, I think: 'For services examining and balancing your cash book for the year ended 31st March, 1901, checking

for not having done the audit? Of course, it may be said that Mr. Shand was going to swindle Mrs. Smith, and therefore it was not to his interest to do so, but certain it is that they have never attempted to do the work of auditing. Mr. Whittaker pointed out a number of things that they did not do. They never asked for the counterfoil receipt book, or for the rough cash book, to compare it with the cash book, or that a single item should be vouched from beginning to end, which is important. Of course, you have to consider the question of the honesty or dishonesty of Mr. Shand. Now, again, you have to look accordingly to Mr. Fosbrooke, who said Mrs. Smith pointed out again and again to him that she wanted the expense brought down as much as possible. Could not Mr. Shand do this, and could not Mr. Shand do that, and it was arranged that Mr. Shand should do this and that—certain things to save time and money. Does that seem reasonable, to say that Mrs. Smith was a reasonable woman? They never dreamt of Mr. Shand being dishonest. He had been in their service some time, and it was never dreamt of. All that she wanted was such a balance sheet as would satisfy the creditors, and they were not going to be satisfied with a Shand's balance sheet, and they got an accountant's balance sheet. That was the object of the employment.

That went on apparently without much important happening until 1904. Now apparently they had no instructions to go beyond the second balance sheet. The creditors were paid off by the end of March, 1904. The creditors were paid off, and therefore there was no necessity, as far as the creditors go, to have the expense of any further balance sheet, and now comes some very important matters about this month. Now the first thing is letters that have passed of July, 1904. Now it is exceedingly difficult to understand what these letters were. One must remember that at this time Mr. Shand—the writer of these letters—had commenced his defalcations, and they had been going on for some months—they had begun, I think, about a year before this, and apparently it is common ground. Mr. Fosbrooke had told Mrs. Smith that he had noticed that Shand smelt of drink, and therefore there might have been a little friction, and apparently there was some accountant whom Mr. Shand rather wanted to be brought in. Now this is written by Mr. Shand: 'We must ask you to push on with our balance sheet to 31st March, 1904. The original arrangement with you was that the cash and bank books were to be balanced and audited monthly. We should be pleased if you will see that this arrangement is carried out in the future.' Now that is not an audit at all. It was the cash book and the bank books that were to be compared. 'The original arrangement with you was that the cash and bank books were to be balanced and audited monthly. We should be pleased if you will see that this arrangement is carried out in the future.' Now that arrangement had been made in Dickinson's time, and was utterly absurd now—utterly absurd. Now this is Mr. Sheard's answer: 'In reply to your letter of the 15th inst., I am proceeding with the balance sheet to March 31st, and hope to hand you the result shortly. I should have completed my work before now if there had not been so many errors, discrepancies and omissions in the books, and in any case I am informed that the stock will not be ready until next Wednesday, so that it would have been impossible to complete the balance sheet earlier. I note that you wish the cash and bank books to be audited and balanced monthly, which shall have attention, but this is the first intimation I have had that you wished the arrangement which was made in Mr. Dickinson's time to be carried out after his retirement. Of course, to do this, it will be necessary for the cash book to be written up and balanced monthly, which has not been done in the past.' Now there was no answer to that. The defendants rely upon that as showing that this was an intimation that there was no complete audit going on.

Well, it is very difficult to see whether what they were complaining of was that they had not been done monthly, or that they had not been done at all. It is very difficult to understand those words. The next is August 16th: 'Dear Sirs,—I beg to advise you that I have got out a trial balance to 31st March of your books, and that they do not balance by the sum of £19 15s. 6d.' That is a trial balance sheet. I daresay, gentlemen, you know it is the first attempt at a balance sheet that is given. 'As the books have not been kept in the manner I instructed, and as I have had to make a number of entries to balance accounts ruled off in error as settled, it appears to me that it will take a considerable time to find the errors

and balance the books. I have already discovered nearly 100 single entries and mistakes amounting to £70. I shall be glad of instructions as to whether you wish me to balance the books or to write the amount off.' Now what Mr. Fosbrooke says to that is 'If I had been an auditor that would have been a perfectly ridiculous letter for me to write, because if I was an auditor I would have to go through every figure. If, on the other hand, my object was to make a balance sheet, why, first it was for my employer to say whether I ought to clear up this discrepancy of £19 15s. 6d.' Now what do they say? Of course, it might be said they ought to have said: Why, you have got to audit and if you have got to audit there cannot be any letters of credit. You must audit and find the actual figures. Then the next letter is: 'We are in receipt of your letter of the 16th inst., and note that you are unable to balance our books by the sum of £19 15s. 6d., and to save further expense you had better write the amount off.' Now that is relied upon very strongly by the defendants as showing Mrs. Smith's object was at that time to save expense as much as possible. She wanted to have a balance sheet which would show her position, but it did not matter to her whether it was £50 one way or the other. Well, then, the letter goes on and disputes the suggestion of Mr. Sheard that they had been making errors and mistakes in their books. They say they have not. They say they have been doing nothing of the sort. 'We believe there is a balance due to you, and will feel obliged if you will send in a statement of particulars to enable us to arrive at a settlement, after which we can go into the matter of fresh terms.' That means the fresh terms will settle up for the old. 'We will then consider whether we shall employ you or not to go into the accounts of the 31st March, 1905.'

Now on the 19th, and before the balance sheet comes, there is an interview, and at that interview there is a conversation, as to which the parties do not differ very much. It is quite clear it did take place. On the 19th, before the accounts had been sent out, in which Mrs. Smith asked, 'What is the amount; what are you going to charge me?' and he said, 'Well, if I charge according to the hours employed it will come to something like 60 guineas.' 'Oh,' said she, 'that is a great deal too much,' and he said, 'Perhaps it is too much. I shall charge you 40 guineas.' 'Oh,' she said, 'that is too much,' and he said, 'Oh, well, I cannot reduce it to less without seeing Mr. Sheard.' They both agree that that took place about that time, and it is fairly common ground that that took place. And, further, this took place: Mrs. Smith says herself, 'I have asked him the terms for a perfect audit'. Now the letter goes on: 'As stated in our interview yesterday, I shall be pleased to undertake the complete audit of your books, and to furnish you with a profit and loss account and balance sheet annually for the future at the following fees, provided the book-keeping is carried out under my supervision and according to my instructions: If one set of books is kept, 30 guineas per annum; if two sets of books are kept, 40 guineas per annum. These amounts would also cover the cost of checking the cash book and bank book monthly, if you wish it done.' Now, gentlemen, there was no answer to that, or the only answer was—Yes, there was an answer: 'We are in receipt of our balance sheet up to 31st March, 1904, together with your letter, which will have our attention in the course of a few days. Your bill of costs for periods ended 30th June, 1903, and 31st March, 1904, we consider excessive, and our Mr. Shand will see you on this matter, after which we can go into the matter of future charges.'

Now, gentlemen, it is a remarkable fact that the defendants never were employed after that to go into the matter. Now that seems of importance. You know if Mrs. Smith was so anxious to see whether her servants were being honest or dishonest there was exactly the same necessity for a full and complete audit then as at any time. Instead of that she never makes any reply to that letter, and never employs the defendants again until after Shand's defalcations are discovered, so that Mrs. Smith—who was so eager, as suggested, to have everything and a complete audit made—had no audit, no balance sheet, or anything during that time until Shand's defalcations were discovered. Of course, she had had a balance sheet up to a certain time because of the creditors. As soon as that was removed she does not seem to have wanted anything at all. You must ask yourselves how does that bear upon the case. Does that look as if she wanted to spend as much money, or to spend a considerable amount of money, in balance sheets and auditing and complete auditing or not?

Now the next thing that happens after these orders is a suggested interview, at which Mr. Sheard is present and not Mr. Fosbrooke, when Mr. Sheard presented his accounts and required payment. The accounts, by the by, were sent on the 20th August, and were acknowledged on the 22nd, when Mr. Sheard was present. Now it does not seem to me that that is an interview of much importance. It took place afterwards. It took place after all the work had been done, and now they have no effect one way or the other upon it. Mrs. Smith's version, corroborated by the book-keeper is this, that she said, 'Mr. Shand tells me you have not done your work properly', and that Mr. Sheard said 'That is a very serious thing. If it is true, it is a serious thing for my clerks. If it is false, it is a serious thing for you. Be good enough to put your complaint in writing.' 'Yes, I will,' says Mrs. Smith. Those are Mrs. Smith's own words, 'And I told Shand to do it'. But it is quite clear that Shand never did do it. It was upon that that Mr. Shee put in letters of August 16th and August 17th, as if that would affect it, but that will not do. The accounts had not been delivered at that time, and it is quite clear that that interview must have taken place a great deal later than August, when they were pressing for payment. Now these accounts were sent in.

Now we must come to these accounts, because it is on these accounts that the plaintiff lays the greatest reliance, and there is no doubt that that account uses the word 'audit'. There is no doubt about it. Now it is said that the word was used in a loose sense, and they must have known perfectly well. They said: 'We have never been pretending to audit in the full sense of the word'; but there it is, and it is a fact in favour of the plaintiff as against the defendants. It is a great point made by Mr. Shee, and you must form your own opinion upon it. Is it an admission that they had agreed to make a complete audit of the books, and had not done so, or is it a loose expression just saying what they have done? 'For services opening books at 1st January, 1903; auditing same for six months ended 30th June, 1903; preparing profit and loss account and balance sheet at that date, and writing up private ledger, £21.' That is for the first six months. The next is, 'Auditing the books for the nine months ended 31st March, 1904; preparing profit and loss accounts at that date and balance sheet at the date, and writing up private ledger, £21.' Now, what Mr. Horridge says as to that is that they used a loose expression, and that is the whole origin of this action. She consulted accountants and other people and they said, 'You have got a case, because in their own bill they put down "audit".'

Now you have to decide. You have heard Mr. Horridge upon it and you have heard Mr. Shee. That is the matter. It is not the contract; it does not pretend to be the contract. You have to see what the contract was that was made in January, 1903, and by looking properly at all the correspondence, and certainly at these accounts, you see what they agreed to do. Well, they squabbled for some time about these accounts, and so on. There are several letters about mistakes on one side and the other, and so on. Apparently Mrs. Smith was dissatisfied, and it was quite plain she was dissatisfied with these bills, and that they were too much; and observe that at this time Mrs. Smith, according to her story, knew that the defendants had not done their duty. Now what does she do? She gives bills in January, 1905—gives two bills, one payable in May and the other payable, I think, in September, and when the May bill becomes due she asks that it may be renewed. It is renewed, and she pays it, and it is only when proceedings are threatened upon the second, which became due in September, that then she formulated, so to speak, the counterclaim which she has brought.

Now the discrepancies were found out. The defalcations were found out in April, 1905. Now Mrs. Smith, according to herself, then knew how badly she had been treated apparently by the defendants, and what does she do? Whom does she employ—whom does she employ to make out the accounts to show these defalcations? She employs the defendants again for that purpose, and you have to ask yourselves what light that throws upon it. According to her she knew that her audit had not been properly done, and that she had suffered by it, and she employed the very people again, and she never formulated a claim against them by any writing so far as we have got. If she is right and she has got a good cause of action against them, she never does that until they press her for the £21 in October, several months afterwards. She said, 'Oh, the reason is I did not want to go to law; I had not money to spend in law', and she seemed to be advised by

her solicitors and accountants, and did not take any steps. But when this claim is made she does, and that is how the matter rests.

There are a number of matters you have heard them discuss by counsel on either side again and again. I will only remind you what you have to say. You have to say whether or not it is proved to your satisfaction that the plaintiff instructed the defendants and the defendants agreed to make a complete audit.

Well, I think there is only one other matter that I omitted, and that is an important one. These balance sheets and profit and loss accounts that were sent in do not contain any signature, or any certificate by the accountants such as usually appears—'Audited and found correct'. Now you heard evidence about that. Mr. Whittaker went so far as to say that because there was no such certificate it must be presumed that there was not a complete audit. That, I think, is going a little too far. The other witnesses said—the plaintiff's witnesses as well as the defendants—that when we have audited that is a certificate that we put on, and the inference, if an inference is to be drawn—as they were not put on—is that there was not a complete audit. Gentlemen, you must judge for yourselves. It is an observation in favour of the defendants that they never put it on, and they would have put it on had they been employed to audit. Therefore it all comes back to this question. You have got to consider—you have to look at the plaintiff's account and what her instructions were—whether the instructions were for a complete audit or not; and if they were, do you accept her account or Fosbrooke's account? According to his account it is quite clear that the instructions were for something different. Now you tell me upon this point whether you find for the plaintiff or for the defendant. If you are satisfied that the agreement was for a complete audit you will find for the plaintiff; but if you find that has not been proved, then you will find for the defendant. We may have to consider hereafter, either you or me, the question of damages, but we will not consider that at present. I will ask you to give your finding first upon the question I have put to you.

The jury retired to consider their verdict.

The jury having returned,

The Associate: Now, gentlemen, have you agreed?

The Foreman: We have.

The Associate: How do you find—for the plaintiff or the defendant?

The Foreman: We find that at the creditors' meeting in London there was a distinct understanding that there was to be a complete audit.

Mr. Justice Bray: You know, you have used the words, gentlemen, that there was a distinct understanding. You know, that looks to me a distinct understanding is not an agreement. Do you find that there was an agreement for a complete audit?

The Foreman: That is so.

Mr. Justice Bray: You find that there was an agreement for a complete audit?

The Foreman: Yes, that is so, my lord.

Mr. Justice Bray (to counsel): What do you say about damages?

Mr. Lindon Riley: What I should have liked was an answer to the question as to whether there was a contract between the plaintiff and the defendant for a complete audit.

Mr. Justice Bray (to the jury): That is what you find?

The Foreman: Yes, my lord.

Mr. Justice Bray: Just let me have the words—what you have got down, you know, because, you see, I want to be sure. (Examined paper which was handed to him.) Oh, that will not do.

The Foreman: Well, we will retire again my lord.

Mr. Justice Bray: No; that will not do, gentlemen. What I must ask you—you must be really careful about this, that contract at the creditors' meeting in London—well, I must tell you that is not the contract; the contract relied upon is the contract made between the plaintiff and Mr. Fosbrooke. I read you the evidence about it. A contract at the creditors' meeting would be a contract between somebody else; that is what you have got to find, you know. I read you the words, you know, and you must go back please, and find, one way or the other, whether that contract is made. That is all I am leaving to you. I am not leaving to you any question of the creditors' meeting at all.

The Foreman: It is very difficult to go past the London meeting, my lord.

Mr. Justice Bray: But you have got to find it one way or the other; the plaintiff has got to satisfy you that the contract was made. Let me have what you have written down.

Mr. Shee: I understand that the jury do first answer the question as to whether there was an agreement or not.

Mr. Justice Bray: Well, Mr. Shee, you shall look at it, and you shall have a copy of it, and you can see what you think of it.

The jury again retired, and upon their return,

The Associate: Now, gentlemen, have you agreed?

The Foreman: We have.

The Associate: Well, how do you find?

The Foreman: For the plaintiff.

Mr. Justice Bray: You find that there was a contract made on that occasion?

The Foreman: Yes, my lord.

Mr. Justice Bray: Very well. For a complete audit?

The Foreman: Yes, my lord.

NEWTON v. BIRMINGHAM SMALL ARMS CO. LTD.*

(Decided by BUCKLEY, J., in the Chancery Division on 27th June, 1906)

Held that articles of association purporting to limit the statutory powers of the auditor of a company are ultra vires

This was the trial of an action brought by Sir A. J. Newton, suing on behalf of the shareholders of the defendant company, against the company, claiming a declaration that a special resolution passed and confirmed in January and February, purporting to alter the company's articles of association by inserting provisions therein for an internal reserve fund, was *ultra vires* and invalid, and an injunction to restrain the company and its directors from acting on such resolution. The new article objected to was so far as material as follows: 'In addition and without prejudice to Articles 132 and 133' [which related to the formation of and dealing with a reserve fund] 'the directors may in any year in which they shall recommend a dividend to be paid on the ordinary shares . . . of not less than 10 per cent. on the amount paid up thereon set aside (without disclosing the fact) out of the earnings or profits in such year remaining after providing the amounts necessary to pay the dividends payable on preference shares and the dividend which they recommend on the ordinary shares such a sum as they may deem necessary or desirable in the interest of the company as an internal reserve fund or as an addition to such internal reserve fund when formed, which internal reserve fund shall be held upon the terms and for the purposes following, that is to say: (a) The internal reserve fund shall be separate from the reserve fund under Article 132, and need not be shown or disclosed by the balance sheet, and the directors need not give any information to the shareholders as to the amount, investment, or application thereof, or otherwise in relation thereto, either in their report or otherwise. (b) Such internal reserve fund may be invested upon such investments (other than the shares of the company) as the directors may in their absolute discretion think fit, without their being liable for any depreciation of or loss in consequence of such investments. . . . (c) Such internal reserve fund may be used and applied at the discretion of the directors for any purpose for which the ordinary reserve fund is available, or for any purposes which the directors in their absolute discretion may consider will serve, protect, or advance the interests of the company, or preserve or promote the value of the undertaking, assets or goodwill of the company. (d) The directors shall disclose the internal reserve fund and the amount thereof, and all additions thereto, and all other particulars in respect of the said fund to the auditors of the company appointed by the shareholders, whose duty shall be to see that the same is applied for the purposes of the company in accordance with the provisions hereinbefore contained, but not to disclose any information with regard to the same to the shareholders or otherwise.'

Mr. Buckmaster, K.C., and Mr. H. K. Newton, for the plaintiffs, contended that the new article was inconsistent with the duties as to auditing a company's accounts under Section 23 of the Companies Act, 1900. The section was almost

* [1906] 2 Ch. 378; 22 T.L.R. 664.

an embodiment of the provisions of Section 7 of the Companies Act, 1879, with reference to the audit of accounts of limited banking companies. The first question was: What would the new article enable the directors to do? They could create an internal reserve as to which there was no supervision, and might use it as they thought fit.

Mr. Justice Buckley suggested that it was authorising the directors to use a secret service fund—a thing which was not unknown.

Counsel, continuing, said that perhaps such a fund had in times past been used for purposes which would be wrong in the case of a private individual. As regards companies, however, which were not banking companies, before the Act of 1900 there was no statutory requirement as to auditing. But apart from statute, the shareholders could insist on the directors' proper management of the company's affairs, and had the right to have accounts so that they might ascertain whether the management had been properly conducted. In *In re Forest of Dean Coal Mining Co.* (10 Ch.D. 450) Sir George Jessel had defined the position of directors, saying: 'Directors have sometimes been called trustees, or commercial trustees, and sometimes they have been called managing partners; it does not much matter what you call them so long as you understand what their true position is, which is that they are really commercial men managing a trading concern for the benefit of themselves and of all the other shareholders in it.' Statutory rights of shareholders, such as the right to petition for winding up, and the right to dissent and be paid out on a reconstruction, could not be excluded or limited by the company's articles—*In re Peveril Gold Mines* ([1898] 1 Ch. 122); *Payne v. Cork Co.* ([1900] 1 Ch. 308). Nor could the statutory right to have proper information under Section 23 of the Act of 1900 be excluded by those means. Section 21 of the Act required the shareholders at each annual meeting to appoint an auditor, and if that was not done one shareholder could ask the Board of Trade to appoint an auditor. Under Section 23 the auditor had to report and certify, and it was not open to the company by its articles to compel an auditor to commit a misdemeanour by disobeying the section. The new article was *ultra vires* and ought not to be allowed to be acted on.

Sir Robert Finlay, K.C., and Mr. R. J. Parker, for the company, said that to a great extent the principles put forward were not disputed. But there was no attempt to make the auditors neglect their duty. The question was whether there was anything in the new articles inconsistent with Section 23 of the Act of 1900 and the duties thereby imposed. Before that Act there was no statutory requirements as to balance sheets. Section 23 did not require a balance sheet. It is said that the auditors must sign a certificate at the foot of the balance sheet, and must report on 'every balance sheet laid before the company'; but the article did not prevent the auditors from correctly certifying and reporting. The object of the article was to prevent information going out which might injure the company and help other concerns. It might not be expedient either to show that a loss had been made on some branch of business, or even that large profits had been made. Nor was it desirable to pay away to shareholders everything which might be distributable as dividend without laying by something for a rainy day. It was only proposed to do, with the assent of the shareholders, what was done every day without their assent. It was well known that there was a practice of writing down the value of assets so as to show a smaller margin for dividends. Each shareholder joined the company on the assumption that his rights might be altered by means of an alteration of articles. Their right to have a balance sheet depended on the articles, and if a balance sheet might be wholly dispensed with it might be dispensed with in part. An auditor might say that on ninety-nine points the balance sheet was right, but that on the hundredth point it did not give any information, because the shareholders were precluded by the articles from requiring that information. As regards rights which were not statutory, these might be controlled by the articles.

Mr. Buckmaster having replied,

His lordship on 20th June said that he would give a written judgment.

JUDGMENT

Mr. Justice BUCKLEY, on 27th June, delivered judgment as follows: In February last this company passed special resolutions the short substance of which is

that the directors may, under defined circumstances, set aside (without disclosing the fact) out of the profits sums to form an 'internal reserve fund'—a sort of secret service fund—and that this fund need not be shown in or disclosed by the balance sheet, and no information need be given to the shareholders as to its amount, investment or application; that the directors may invest it as they think fit without being liable for loss in consequence of such investments; that they may apply it for any purposes which they consider will advance the interests of the company; and that, while the particulars as to this fund are to be disclosed to the auditors, it is to be the auditors' duty not to disclose any information with regard to it to the shareholders or otherwise.

The question for decision is whether, having regard to Sections 21 to 23 of the Companies Act, 1900, these special resolutions are *ultra vires*. The Companies Act, 1862, was silent as to accounts. Table A (which the company might or might not adopt, as it chose) contained provisions on the subject, but otherwise the Act left the matter untouched, relying, no doubt, upon the application of the ordinary principles applicable as between partners and proceeding upon the footing that the members of a company under the Act are partners in a special sort of partnership modified and governed by statutory provisions. The Companies Act, 1879, Section 7, contained, for the first time, provisions as to audit of accounts, and was confined to banking companies registered after 1879 as limited companies. The Companies Act, 1900, Sections 21 to 23, for the first time contained provisions as to the audit of the accounts of other companies under these Acts. The provisions of the Act of 1879 and those of the Act of 1900 are closely similar, though not the same; so similar, indeed, as that the reason for the difference is hard to see. The principal differences that I trace are that the Act of 1879 does, while the Act of 1900 does not, provide affirmatively for an annual audit, and that the Act of 1879 does, while the Act of 1900 does not, provide that if there is no auditor a meeting shall be forthwith called to elect an auditor. As regards the former of the differences, I think that the Act of 1900 (though it does not do so expressly) yet does impliedly provide for an annual audit. Section 21, subsection 1, requires the annual appointment of an auditor to hold office for one year, and the Act contemplates that he will audit during his tenure of office. There will thus result an annual audit. As regards the latter difference, I find that Section 21, subsection 2, provides for the appointment of an auditor by the Board of Trade on the application of any member in case an auditor has not been appointed at the annual meeting. Neither statute contains any provision in favour of the public in the matter of publication of the accounts. The two statutes really do not differ, I think, in substance in their result.

The question is how far the Act of 1900 goes in requiring for the protection of the members that the accounts shall be open to audit and that the report on them shall be made to the members. The defendants do not dispute that, if and so far as the special resolutions are inconsistent with the Act, it is the Act which must prevail. The concluding sentence of Section 23 requires that the auditor shall state whether the balance sheet exhibits a true and correct view of the state of the company's affairs as shown by the books. Sir Robert Finlay argued that these words are satisfied if the auditor's report that the balance sheet does not exhibit a true view and that the statute does not, in these words, say that they shall report what is the true view. This is logically true as regards the language, but, in my judgment, the statute is saved from the reproach of having achieved no more than this impotent result by words earlier in that section, which provide that the auditors are to report to the shareholders on the accounts. A report upon the accounts involves a report of the result of the accounts, and this necessarily involves, as matter of substance if not of form, the statement of a balance sheet or the equivalent of a balance sheet.

There are, I agree, in the Act of 1900 no affirmative words to the effect of what I am about to state, but I think the language of the Act is sufficient to show that by implication it requires that there shall be annually an audit of accounts resulting in a balance sheet, to the accuracy of which the auditors shall speak. The special resolutions in the present case provide that the balance sheet shall not disclose the internal reserve fund. It must therefore omit on the assets side of the balance sheet the assets which make up the amount standing to the credit of that fund and the *contra* item—namely, the credit balance of the fund—on

the liability side. The result will be to show the financial position of the company to be not so good as in fact it is.

If the balance sheet be so worded as to show there is an undisclosed asset, the existence of which makes the financial position better than shown, such a balance sheet will not, in my judgment, be necessarily inconsistent with the Act of Parliament. Assets are often, by reason of prudence, estimated, and stated to be estimated, at less than their probably real value. **The purpose of the balance sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not or may not be better. The provision as to not disclosing the internal reserve fund in the balance sheet is not, I think, necessarily fatal to the special resolutions.** The Act, however, provides that the auditors shall report to the shareholders on the accounts examined by them. These auditors will examine, among others, the accounts of the internal reserve fund. A principal question in this case, I think, is whether it is a compliance with these words of the Act that the auditors shall report that they have examined the accounts as to the internal reserve fund, that they are satisfied with them, and that the funds have been employed in manner authorised by the company's regulations, or whether there will be a default in complying with the Act if they do not go on to say how the fund has been employed. In my judgment such a report would be a sufficient report within the Act if the auditor is bona fide satisfied that in making this report, and nothing further, he is truly reporting as to 'the true and correct view of the state of the company's affairs'.

But the special resolutions do not stop there. They provide that it shall be the duty of the auditor not to disclose any information with regard to this fund to the shareholders or otherwise. **It is, I think, inconsistent with the Act of Parliament that the auditor should be bound, even when he thinks that the true state of the company's affairs is affected by facts relating to the internal reserve fund, to withhold all information with regard to the same from the shareholders. If, for instance, the directors had invested the internal reserve fund upon investments which might involve the company under certain circumstances in enormous loss, the Act, I think, requires that the auditor shall be at liberty and be bound to report that fact.** In reporting upon the accounts submitted to them the auditors do not, of course, report as to the details of the accounts to which they find no cause to take exception. Their duty is to call attention to that which is wrong, not to condescend upon all the details of that which is right. It is, I think, competent to the statutory majority of the shareholders to say that as to particular items of their business it is to the interest of the corporation that there shall be secrecy, and that the auditors, who must for the purposes of their audit know all such details, shall not, unless their duty under the statute requires it, disclose such details to the members.

There is no suggestion in this case that these clauses are intended to be used for any other than a legitimate purpose. Those who are engaged in commerce are familiar with the fact that undue publicity as regards the details of their trade, or as to their financial arrangements, may often be injurious to traders, having regard to the rivalry of competitors in trade, to complications sometimes arising from strained relations between capital and labour, and the like. There are legitimate reasons for ensuring secrecy to a proper extent. It is not, I think, necessary, nor, having regard to the great utility of these Acts, is it desirable to expose persons who trade under these Acts to the necessities of a publicity from which their competitors are free unless such publicity is required to ensure commercial integrity. I am not disposed to look too closely for reasons why I should find clauses such as these to be inconsistent with the Act if I see that the true purpose of the Act is satisfied. I think, however, that these special resolutions go too far. **Any regulations which preclude the auditors from availing themselves of all the information to which under the Act they are entitled as material for the report which under the Act they are to make as to the true and correct state of the company's affairs are, I think, inconsistent with the Act.** The defendants have left me in some doubt as to the exact position which they take up in the matter. They have desired to obtain the opinion of the Court upon the general question under the Act. They are entitled to do so, and this judgment I hope will put them in possession of my views on the subject, but

I am not clear whether they threaten and intend to act upon the resolutions as they stand. They say, truly, that as regards the details of the resolutions, when they know the view of the Court upon the Act of Parliament, they can by further special resolutions alter their scheme so as to make it consistent with that view. There are no pleadings, so that it is only from the attitude of the defendants at the Bar that I can ascertain whether they threaten and intend to do the act against which an injunction is sought. It is not according to the practice of the Court to enjoin an act unless the defendants threaten and intend to do it. I postpone, therefore, for the moment the question of the exact form of the order so that I may hear what the defendants have to say.

Mr. R. J. Parker said that the company did not intend to act on the new article in its present form and suggested that a declaration that it was *ultra vires* so far as inconsistent with the Act of 1900 would be sufficient. It was pointed out that there might be some difficulty in case an appeal was brought from his lordship's judgment, and, after some discussion, his lordship granted an injunction to restrain the company from acting on the special resolution, and ordered the company to pay the costs.

THE LIVERPOOL AND WIGAN SUPPLY ASSOCIATION LTD.*

(Decided by his Honour Judge THOMAS, in the Liverpool Court of Bankruptcy, on 14th June, 1907)

Held that, to establish a claim for misfeasance, it must be shown that the company has sustained an actual loss

This was a case in connection with the winding up of a grocery and provision concern named 'The Liverpool and Wigan Supply Association Ltd.'

Mr. J. W. Wall, solicitor, appeared on behalf of Mr. John M'Cormick, chartered accountant, Liverpool, the liquidator of the company, and moved the Court, under Section 10 of the Companies Act, 1890,† for an order on Mr. Arthur Campbell, chartered accountant, Booth Street, Manchester, 'To contribute such sum of money to the assets as to this Court may seem fit and proper, by way of compensation in respect of his misfeasance and neglect of duty as auditor of the company, for that he being auditor of the company did make balance sheets for the half-years ending the 30th day of June, 1905, and the 31st day of December, 1905, which were incorrect and misleading, and that the said Arthur Campbell did not use reasonable care and skill in the making and preparing of such balance sheets, and neglected his duties as auditor of the said company, and thereby caused loss of assets, and damage to the shareholders and creditors of the said company.'

Mr. Wall stated that the respondent had acted as auditor of the company from its formation in May, 1899, to the winding-up order in August, 1906, when there was £879 due to unsecured trade creditors, and the assets realised had not been sufficient to pay the initial costs of winding up. The business of the company was mainly carried on in a shop in Standish Gate, and the Market Hall, Wigan, and Mr. Wall proceeded to quote figures from the half-yearly balance sheets as audited and certified by the respondent, the main points on which the present motion was founded being that book debts, to a considerable amount, were again and again included in the assets when with reasonable care and skill the auditor could have ascertained that they were worthless, and that the half-yearly balance sheets in question did not show the true position of the company on the dates given, inasmuch as they included in both instances receipts to about a week later, without having regard to the purchases during the interval, which had increased the debits of the company. Mr. Wall cited a number of cases bearing on the question of the duties of auditors, amongst them the judgment of Lord Justice Lopes in the *Kingston Cotton Mill* appeal case, in which his lordship laid it down, 'It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care and caution must

* *The Accountant* L.R. [1907] 4.

† Now Section 333 of the Companies Act, 1948.—Ed.

depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion, or with a foregone conclusion that there is something wrong. He is a watch-dog, not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything to excite suspicion, he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful.' Later in the judgment his lordship held, 'It is not the duty of an auditor to take stock—he is not a stock expert. There are many matters in which he must rely on the honesty and accuracy of others. He does not guarantee the discovery of all fraud.'

On this and other cases cited, Mr. Wall submitted that directors are entitled to presume that the auditor does his work properly, and that relieved them from any onus in the matter. He then read the affidavit of the liquidator, setting out the points complained of in regard to the audits, and remarked that the present was a class of case that very seldom came into Court, thus giving rise to the suggestion often heard that under the Companies Acts people from whom redress was wanted could not be reached. He felt in the public interests that it was a case that ought to be brought into Court for consideration, whether there was misfeasance or not, and he did not think it should be a factor whether the auditor was able to pay or not.

The Judge: I think you are right there.

Mr. Wall: The proceedings are not brought with any vindictive feeling against the auditor personally, but the certificates of auditors are so much relied upon commercially that it is very important that the public should know that where auditors' certificates are wrongly given they may be, and will be, attacked. Mr. Wall proceeded to support his motion by reading extracts from the observations of the Official Receiver of Liverpool upon the failure.

Bernard M'Guirk was then called, and was cross-examined by Mr. Courthope Wilson. He, for about a month after the formation of the company, was a director, and he then retired, as he was a creditor for about £400, and thought he should not remain a director. He alleged that he had lost heavily owing to the incorrect state of the balance sheets, which had shown that 20s. in the £ could be paid if the company were wound up. He was never a promoter of the company, though Mr. Oliver, whose business was taken over by the company, owed him at the time about £400. Oliver, who was the managing director, was instructed to keep a cash book and ledger, and witness did not know, until the winding-up proceedings, that no cash book was kept.

The Judge: Did you hope that the formation of this company would help to pay off your old debt?

The witness: No; there was money in the bank then.

In reply to a further question by Mr. Courthope Wilson, witness admitted that he, as a shareholder, saw the balance sheet in December, 1899, and that it bore a certificate by the auditor to the effect that information and figures it contained on certain points were obtained by the auditor from Mr. Oliver.

Mr. Courthope Wilson, in his statement for the defence, said he would call Mr. Campbell, if necessary, but his (counsel's) case was a very simple one. Under Section 10 of the Companies Act, 1890—which is the misfeasance section—it had been established that the section did not create any new rights, and only provided a summary remedy for enforcing rights a company would have had apart from the alteration under the old Act. To bring the present case within the section, Mr. Wall must prove a breach of trust by an officer of the company, and he must prove loss to the company by reason of that breach of trust.

The Judge: The present is not a complaint by the company, but by a creditor of the company.

Mr. Courthope Wilson: It is the liquidator who is claiming. He cannot have a claim unless the loss is a loss by which the assets of the company are diminished. Counsel proceeded to cite a case in which the Court of Appeal had held that misfeasance in Section 10 meant misfeasance in the nature of a breach of trust, and he also cited a decision of the House of Lords to show that the loss must be a loss to the company.

The Judge: The result of the cases cited is that in these circumstances you cannot, according to your contention, recover under this section.

Mr. Courthope Wilson: Yes.

The Judge: Is there any remedy at all?

Mr. Courthope Wilson: Yes. It might be done by a common law action by a creditor personally, but I submit this is M'Guirk's action really. As he said in the box, he had been 'induced to trust the company on account of these balance sheets', but it is clear that it was not in consequence of these balance sheets he was induced to trust the company—he went on and increased his debt—but whether he acted on the balance sheets or not, there is no loss to the company. There is no diminution or loss to the assets of the company, and that must be shown in order to enable this application to succeed. Counsel proceeded to criticise the report of the liquidator, and a long legal argument ensued on various points.

The Judge: Whether there is breach of duty or breach of trust, to succeed on this application must not you show that there is a loss to the company?

Mr. Wall: If I say there is a breach of duty that is all I need show, but I contend there has been loss to the company, inasmuch as the assets shown were about £900, and the result we have obtained from the assets is £23 0s. 9d. One balance sheet showed £46 in the bank, whereas it should have shown 13s. 1d.

The Judge: Whose is the loss?

Mr. Wall: The company—the shareholders and creditors.

The Judge: All the assets would have been wiped out by the creditors at that time.

Mr. Wall: I take it the law must not be strained to say who would have got the assets—they belonged to the company and the company have lost them.

The Judge: The loss is to the unfortunate creditors. There is no doubt Mr. M'Guirk went on trusting the company, but whether on these balance sheets or not I don't think it is necessary to determine. You have to show me that the assets of the company have been diminished by the misrepresentations in these balance sheets.

Mr. Wall: Assuming there is an amount in the bank on any particular date, and the company had passed a resolution to wind up, the company would have been in possession of that money.

The Judge: Yes, but you have to show me that the company has lost something.

Mr. Wall: The money comes to the company first, and they distribute it, so I submit it cannot be said that the money lost is the creditors' money, because there is not enough to go beyond them. The company as a body has lost that money by not getting it into its assets. The company must get the money before it is distributed to the creditors. Is not that the true position? If not, I don't see that I can carry it further.

JUDGMENT

The Judge: In this case I think that the auditor was negligent as an auditor in the sense that he relied on statements made to him by the directors, and did not put in his certificate the fact that he was relying on the statements of the directors. The auditor did not disclose that there was no cash book, and, if it were material in this case to say so, I think the auditor ought to have disclosed it. I don't think he ought to have accepted the statements of a director as to the taking of stock, and the balance sheets should have shown the position of the company on the dates they purport to have shown the position. But none of these acts appears to me to have diminished the assets of the company as such. What may have happened is that the creditors went on dealing with the company longer than they otherwise would have done, but I have no evidence before me that satisfies me that even that was the case, and with respect to creditors this is not the proper form of procedure, if they have any remedy at all. I think Mr. Courthope Wilson is right that **under this form of proceeding it must be established that there has been breach of duty that has resulted in some actual diminution of the assets of the company.** And in regard to the statement as to the book debts, there is no evidence that at any time those could have been collected, but in fact the report shows to the contrary. In regard to the amount that ought to have been to the credit of the company at the bank, that is accounted for in the statement as to the extent of the company's assets, and it is not anything that diminishes the company's assets,

consequently no evidence has been brought before me to show that the assets of the company have been diminished by anything the auditor has done and these proceedings, I think, must fail.

Mr. Courthope Wilson asked for costs.

The Judge: I give no costs.

REX v. SOLOMONS*

(Decided by Lord ALVERSTONE, C.J., and DARLING and JELF, JJ., in the Court of Criminal Appeal, on 17th July, 1909)

Held that a mechanical check (in this case a taximeter) is an 'account' within the meaning of the Falsification of Accounts Act, 1875

The appellant was a taximeter cab driver, and had been in the habit of taking out one of the cabs belonging to the General Motor Cab Co. He had been convicted of falsifying the taximeter, by driving fares, from whom he had taken money, without putting down the flag which set the taximeter at work. There were also charges under the Larceny Act, 1901. It appeared that on a consecutive number of days the appellant had driven two music-hall artistes from one music-hall to another and back, without putting the flag of the taximeter down. For each journey he was paid 9s., which was less than the amount that the taximeter would have registered had it been working. At the end of the day, it was customary for the drivers of cabs belonging to the company to sign a paper, which was an account of the day's takings, recorded by the taximeter clerk, from the figures registered by the taximeter itself. Of the amount so registered and checked, the driver was entitled to one-quarter and the company to three-quarters. It was contended for the appellant upon appeal against conviction that there was no contract of service between him and the company. It was true that there were various notices and regulations concerning the drivers, one of which was to the effect that a driver who absented himself, without special leave, for more than twenty-four hours was liable to instant dismissal, which might suggest a contract of service. On the other hand, there were other matters to show that there was no such contract, such as the lack of any control by the company over the drivers, once the cabs had left the company's premises. Drivers could go where they pleased and were subject to no orders. The Common Serjeant had told the jury that he had grave doubt as to whether the appellant was a servant within the Act dealing with falsification. For the Crown, in respect only of the question as to whether a taximeter was an account, it was contended that a taximeter machine was an account within the Act of 1875. There was nothing in the statute to show that an account must be on paper. The machine on one side had a record of the number of miles run, which record, in this case, was untrue. The number of miles traversed would show how much the driver ought to have received. The paper drawn up by the clerk was copied from the machine, and both paper and machine were accounts, just as much as a ledger and day book.

JUDGMENT

Held, that an offence was committed when the taximeter, which was an account within the meaning of the Act, was falsified, that the appellant, being a servant of the company, was rightly convicted of falsification under the Act of 1875; and that therefore the appeal must be dismissed.

In re JAMES WILLIAMS (deceased) and *In re* THE PUBLIC TRUSTEE ACT, 1906†

(Decided by SWINFEN-EADY, J., in the Chancery Division, on 7th July, 1910)
Held that trustees must produce accounts to an auditor appointed under the Public Trustee Act, 1906, without seeking to impose terms

This was a summons by an auditor appointed by the Public Trustee under Section 13 of the Public Trustee Act, 1906, to investigate the condition and

* *The Accountant* L.R. [1909] 22.

† 26 T.L.R. 604.

accounts of the trusts of the testator's will, and it asked that the trustees of the will should be ordered to produce to him the books, accounts, and other documents relating to the trusts. There was also a summons by John Williams, the acting trustee, asking for the discharge of the auditor, or in the alternative that the audit should be limited to accounts of capital money. The testator, a brickmaker and contractor, died in 1886, having devised and bequeathed all his property to two sons, one of them his partner, and to a co-partner on trust for sale and conversion (with power to postpone), and there were separate trusts of the income and capital. Out of the former, annuities were given to six of the testator's children and two orphan grandchildren, the surplus income being given to the two other sons (the trustees), and on the death of each of the six children a capital sum was settled on his or her family, a lump sum being also payable to the two grandchildren on the younger of them attaining 21, when their annuities were to cease. The two trustee sons were residuary legatees. There was a clause in the will under which if any of the above-named beneficiaries commenced an action in the High Court in respect of the trusts, the whole of the costs were to fall on his or her share. Three of the children had died, and the younger grandchild had attained 21 in 1900, but the trustees had raised none of the capital sums due on these events, but had paid interest thereon at 4 per cent., alleging that the complicated nature of the testator's property, which consisted largely of ground rents and house property, at Hammersmith, rendered it impossible to realise the capital required. It appeared, however, that on the falling in of a lease of part of the property they had granted a renewal and taken a fine of £2,000, which in the absence of any direction to the contrary in the will, they had treated as income, dividing it between themselves as surplus income. On the appointment of the auditor, which was made on the application of one of the grandchildren, the acting trustee had declined to produce the necessary books and documents except on the terms of the costs of the audit being borne by those who asked for it. The other trustee was said to be willing that the audit should proceed.

JUDGMENT

Mr. Justice SWINFEN-EADY said that, in his opinion, there was no answer to the auditor's summons. Being appointed by the Public Trustee he had a right to all books and other necessary documents, and the trustee was in error in refusing to produce them except on terms. There would, therefore, be an order for access, including access to the partnership books, and John Williams must pay the costs. The other summons was a different matter. It raised the question whether the audit should not be limited to capital, but it should be observed that it first asked that the investigation and audit should not be proceeded with at all. He saw no grounds for that claim and refused it, being of opinion that investigation was necessary. Nor was there any ground for limiting the audit to capital matters. It appeared that £2,000 had been received and divided between the residuary legatees as income, they at the same time alleging that there was no money to pay the settled portions. The Court had no information as to the testator's share in the partnership business. His lordship was of opinion that the audit should not be limited to capital, though it might be that on looking into the accounts the auditor might find it possible to confine his investigation, and it was not to be anticipated that a person selected by the Public Trustee would incur undue expense. At the present time no directions as to scope could be given, and this part of the second summons would stand over generally.

In re THE SPANISH PROSPECTING CO. LTD.*

(Decided by COZENS-HARDY, M.R., and FLETCHER MOULTON and FARWELL, L.JJ., in the Court of Appeal, on 9th November, 1910)

Held that when a salary is payable out of profits, such profits are not necessarily the profits shown by the company's annual accounts, but may include accretions of capital

This was a considered judgment of the Court of Appeal reversing the decision of Mr. Justice SWINFEN-EADY. The facts are sufficiently set out in the judgment of the Master of the Rolls.

* [1911] 1 Ch. 92; *The Accountant* L.R., Vol. XLIII, pp. 57 and 61.

JUDGMENT

COZENS-HARDY, M.R.: This appeal turns upon the meaning of the word 'profits'. The company is in voluntary liquidation. The creditors, except Messrs. Punchard and Vivian, have been paid in full, and all the subscribed capital has been returned, and there is a surplus of upwards of £3,000 in the hands of the liquidator, and this sum, less costs, is claimed by Punchard and Vivian under the following circumstances:

By an agreement dated the 4th June, 1901, Punchard and Vivian were, for the valuable consideration therein mentioned, to receive a salary at the rate of £41 13s. 4d. per month each, subject to the proviso that they should not be entitled to draw their salary 'except only out of profits', if any, arising from the business of the company which may from time to time be available for such purpose, but such salary shall nevertheless be cumulative, and accordingly any arrears thereof shall be payable out of any succeeding profits as aforesaid. The business of the company included the purchase and sale of shares. In 1901 the company purchased 6,000 fully-paid shares of £1 each in the Spanish Minerals Development Ltd., the consideration being the allotment of 6,000 fully-paid shares in the Prospecting Co. Twelve hundred of the Development Co.'s shares were sold, leaving 4,800 on the company's hands. The Development Co. was wound up and the Prospecting Co. received in respect of their holding: (a) £3,840 in cash, (b) £3,840 debentures of the Esperanza Copper & Sulphur Co. Ltd. (which had acquired part of the property of the Development Co.), and (c) 3,360 shares in the Esperanza Co. In the balance sheet for 1906 the cash was subtracted from the £4,800 and the shares were put up as an asset at the figure of £960. A note was added that the company had also received items (b) and (c), but no value was attributed to them in the balance sheet. In 1907 the shares (item c) were sold, and the proceeds were carried to the credit of the profit and loss account, and it was stated that there would be a further credit when the debentures (item b) were realised. In 1908 the report of the directors stated that the debentures were still in the hands of the company, and that it was proposed to wind up the company. The debentures were sold by the liquidator shortly after his appointment. There was no goodwill and no fixed capital. The assets consisted solely of cash and loans and shares, and these debentures. Mr. Justice Swinfen-Eady has held that at the commencement of the winding-up the debentures formed a part of the assets of the company, but that there was still a debit balance on profit and loss account, and that the company's business came to an end with the winding-up, and that the claimants were not entitled to be paid.

With great respect to Mr. Justice Swinfen-Eady, I am unable to agree with this conclusion. The proceeds of 6,000 shares from time to time realised by the company were properly entered on the accounts and placed to the credit of profit and loss. This appears from the accounts for 1907. The balance sheet for the same year recognises that the company held the debentures which had at present no market quotation, and the directors did not put any estimate of value upon them. The liquidator has, however, realised these debentures, and I can see no reason why the proceeds should not be placed to the credit of profit and loss. The realisation of this asset was not a new business carried on by the liquidator. If goods are sold and bills given by the purchaser which have not matured at the commencement of the winding-up, the liquidator can collect the bills or discount them without embarking on new business.

The language of Lord Justice Lindley in the *Bridgwater Navigation Co.* case ([1891] 2 Ch., p. 317) seems to me to be a clear authority in support of this view. He points out that although, while the company was carrying on business, debts owing to it were underestimated, this was done from motives of prudence, but that when the actual value was known the difference between the estimated and ascertained value really represented overdrawn profits. In the present case no estimate was put upon the debentures, and the result is that the entire proceeds realised by the liquidator should be treated as overdrawn profits arising from the company's business, out of which the claimants are entitled to be paid. It follows that, in my opinion, the appeal should be allowed, and the claimants should be declared entitled to the balance in the hands of the liquidator, subject to the costs of the liquidation including the liquidator's remuneration and the costs of this summons here and below.

FLETCHER MOULTON, L.J.: The question for our decision on the present case is of some general interest, because it follows upon the legal meaning of the word 'profits', and inasmuch as I believe that the decision of the learned judge in the Court below is erroneous, and that uncertainty and error in so fundamental a matter may lead to serious confusion. I shall, in the first place, consider the general question and then proceed to deal with the special points of the case.

The word 'profits' has, in my opinion, a well-defined meaning, and this meaning coincides with the fundamental conception of 'profits' in general parlance, although in mercantile phraseology the word may at times bear meanings indicated by the special context, which deviate in some respects from the fundamental signification. 'Profits' implies comparison between the state of a business at two specific dates, usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.

For practical purposes these assets in calculating profits must be valued and not merely enumerated. An enumeration might be of little value. Even if the assets were identical at the two periods, it would by no means follow that there had been neither gain nor loss, because the market value—the value in exchange—of these assets might have altered greatly in the meanwhile. A stock of fashionable goods is worth much more than the same stock when the fashion has changed, and to a less degree, but no less certainly, the same consideration must apply to buildings, plant and other fixed assets used in the business, because one form of business risk against which business gains must protect the trader is the varying value of the fixed assets used in the business. A depreciation in value, whether from physical or commercial causes, which affects their realisable value is in truth a business loss.

We start, therefore, with this fundamental definition of 'profits', viz. if the total assets of the business at the two dates be compared the increase which they show at the later date as compared with the earlier date (due allowance, of course, being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question.

But the periodical ascertainment of profits in a business is an operation of such practical importance as to be essential to the safe conduct of the business itself. To follow out the strict consequence of the legal conception in making out the accounts of the year would often be very difficult in practice. Hence the strict meaning of the word 'profit' is rarely observed in drawing up the accounts of firms or companies. These are domestic documents designed for the practical guidance of those interested, and, so long as the principle on which they are drawn up is clear, their value is diminished little, if at all, by certain departures from this strict definition which lessen greatly the difficulty of making them out. Hence certain assumptions have become so customary in drawing up balance sheets and profit and loss accounts that it may almost be said to require special circumstances to induce parties to depart from them. For instance, it is usual to exclude gains and losses arising from causes not directly connected with the business of the company—such, for instance, as a rise in the market value of land occupied by the company. The value assigned to trade buildings and plant is usually fixed according to an arbitrary rule, by which they are originally taken at their actual cost and are assumed to have depreciated by a certain percentage each year, though it cannot be pretended that any such calculation necessarily gives their true value either in use or in exchange. These, however, are merely variations of practice by individuals. They rest on no settled principle. They mainly arise from the sound business view that it is better to underrate than to overrate the profits, since it is impossible for you to foresee all the risks to which a business may in future be exposed. For instance, there are many sound business men who would feel bound to take account of depreciation in the value of business premises, or in the value of plant especially designed for the production of a particular article, although they would not take account of appreciation in the same arising from like causes.

To render the ascertainment of the profits of a business of practical use it is evident that the assets, of whatever nature they be, must be represented by their money value. But as a rule these assets exist in the shape of things or rights, and not in the shape of money. The debts owed to the company may be good, bad or doubtful. The figure inserted to represent stock-in-trade must be arrived at by a valuation of the actual articles. Property, of whatever nature it be, acquired in the course of business has a value varying with the condition of the market. It will be seen, therefore, that in almost every item of the account a question of valuation must come in. In the case of a company like that with which we have to deal in the present case, the process of valuation is often exceedingly difficult, because the property to be valued may be such that there are no market quotations and no contemporaneous sales or purchases to afford a guide to its value. It is not to be wondered at, therefore, that in many cases companies that are managed in a conservative manner avoid the difficulty thus presented, and content themselves by referring to assets of a speculative type without attempting to affix any specific value to them. But this does not in any way prevent the necessity of regarding them as forming a part of the assets of the company which must be included in the calculations by which *de facto* profits are arrived at. Profits may exist in kind as well as in cash. For instance, if the business is, so far as assets and liabilities are concerned, in the same position that it was the year before, with the exception that it has contrived during the year to acquire some property, say mining rights, which it had not previously possessed, it follows that those mining rights represent the profits of the year, and this whether or not they are specifically valued in the accounts.

But though there is a wide field for variation of practice in these estimations of profit in the domestic documents of a firm or company, this liberty ceases at once when the rights of third persons intervene. For instance, the Revenue has a right to a certain percentage of the profits of a company by way of income-tax. The actual profit and loss accounts of the company do not in any way bind the Crown in arriving at the tax to be paid. A company may wisely write off liberally under the head of depreciation, but they will be only allowed to deduct the sum representing actual depreciation for the purpose of calculating the profits for the purpose of income-tax. The same would be the case if a person had a right to receive a certain percentage of the profits made by the company. **In the absence of special stipulations to the contrary, 'profits', in cases where the right of third parties come in, mean actual profits, and they must be calculated as closely as possible in accordance with the fundamental conception, or definition to which I have referred. I would have it clearly understood that these remarks have no bearing upon the vexed question of the fund out of which dividends may legally be paid in limited companies.** Cases such as *Verner v. The General and Commercial Investment Trust* and *Lee v. Neuchatel Asphalte Co.* show that this fund may in some cases be larger than what can rightly be regarded as profits, and the decisions in these cases depend largely on the fact that there is no statutory enactment which forbids it to be so. In the present case, however, no question as to the limitations of the fund arises, so that I shall not make any further references to these decisions or to the principles on which they rest, as they do not affect the matter before us. (The learned lord justice then applied the foregoing principles to the facts of the case, and ruled that the appeal should be allowed.)

FARWELL, L.J., in agreeing to the reversal of the judgment in the Court below, said that money which had in fact resulted from the profits made in trade is none the less profit because it is carried over to a suspense account or to a reserve fund. If it be lost in trade there is an end of it, but so long as it remains *in statu quo* it remains as undistributed profits. The profits arising from the business of a company are not necessarily the same as the profits of that company. A company may have fixed capital as well as circulating (as I have endeavoured to explain in *Bond v. Barrow Haematite Co.* ([1902] 1 Ch. 353)) and in that case the profits of its business would be those arising from the use of its circulating capital excluding its fixed capital. For instance, the profits arising from a trader's business would not include the increase of the cost price of a freehold warehouse used in the business and afterwards sold. But in this case the company acquired in the course and for the purpose of its business certain shares and debentures in the

Esperanza Co. It is not suggested that the company had anything that could be called fixed capital. The learned judge in the Court below had decided on the authorities that the surplus of realised assets on winding-up over and above the subscribed capital was not a profit arising from the business of the company. This, in my opinion, depends upon the nature of the company's business and assets, and cannot be predicated as universally true of all companies, and the authority of *Frames v. Bultfontein Mining Co.* ([1891] 1 Ch., p. 140), on which the learned judge relied, is really our authority against his decision.

ARTHUR FRANCIS LTD.*

(Decided by SWINFEN-EADY, J., in the Chancery Division, on 4th April, 1911)
Held that any lien an accountant may have upon a company's books must not be allowed to embarrass the winding-up of such a company

This was a Court summons issued at the instance of the liquidators of Arthur Francis Ltd.—Mr. E. H. Hawkins and Mr. H. C. Hicks—against Messrs. Linnett and Davis, chartered accountants, asking for an order for the handing over of certain books belonging to the company.

Mr. J. S. Green, who appeared for the appellants, explained that the respondents were formerly the accountants and auditors of Arthur Francis Ltd. On 15th November, 1910, a resolution was passed to wind up the company voluntarily, and Mr. H. C. Hicks was appointed liquidator. Subsequently an ordinary creditors' meeting was held on 14th December, and Mr. Hawkins was appointed by the Court as joint liquidator with Mr. Hicks. They asked the respondents in the present case to produce to them a ledger which they admitted they had, but they declined to do so, on the ground that there was an amount of £47 3s. 4d. owing to them in respect of their work as auditors, and £27 18s. 4d. for their work as accountants. The respondents contended that they had a lien on the books, but he (counsel) submitted that the directors had no power to give any such lien, because, under the articles of association, the books were to be kept at the company's office, and therefore they could not be subject to any lien. The only book he wanted was the private ledger, and he asked his lordship to make the necessary order for the respondents to deliver it up.

Mr. Whinney, for the respondents, said he claimed a lien over the books and documents in their possession relating to the company, on the ground that they had worked upon them, and had not been paid either their audit fees or accountancy charges.

The judge observed that he did not think the respondents could be allowed to embarrass the winding-up of the company by keeping the books. He should have thought that the ledger was a most essential book for the purposes of the liquidation.

Mr. Whinney said his point was that he could not help producing the book to the Court, but he submitted that its production must be without prejudice to his lien.

JUDGMENT

His lordship made an order that the books should be produced, without prejudice to the lien (if any) of the respondents, and remarked that he hoped, as a result of the investigation, it would be shown that the assets would be sufficient to pay the respondents their charges.

HENRY SQUIRE (CASH CHEMIST) LTD. v. BALL, BAKER & CO. and MEAD v. SAME†

(Decided by Lord ALVERSTONE, C.J. (sitting by consent without a jury), in the King's Bench Division, on 16th February, 1911)

Consolidated actions for damages for alleged negligence brought: (a) by a company against its auditors; (b) by a shareholder and director of such company against a

* *The Accountant* L.R., Vol. XLIV, p. 61.

† *The Accountant* L.R., Vol. XLIV, p. 25.

firm of chartered accountants employed to investigate books of vendor to such company. Responsibility for failure to detect systematic fraud.

These were actions to recover damages from the defendants for negligent performance of their duties as auditors.

The action by Henry Squire Ltd. was taken first. The defendants denied that they had been guilty of negligence, and further said that owing to a provision in the plaintiff company's articles they were free from any liability for negligence, as the articles provided that officers of the company should only be responsible for dishonesty, and this was not alleged.

The hearing occupied nearly four days. It was begun before the Lord Chief Justice and a special jury on 9th February, but before the opening statement of Sir Edward Clarke had been concluded, the jury was discharged by consent of the parties.

Sir Edward Clarke, K.C., Mr. Holman Gregory, K.C., and Mr. G. L. Hardy appeared for the plaintiffs; and Sir E. Carson, K.C., and Mr. Bremner appeared for the defendants.

Sir E. Clarke, in opening the case for the plaintiffs, said that for about ten years before 1903 a Mr. Reece had carried on business as a cash chemist at various shops in London in the name of Henry Squire. Owing to the opening of new branches Reece required financial assistance, and at the end of 1902 he had raised £1,200 on mortgage from a solicitor named Mead. Early in 1903 he wished to obtain more money, but Mead was getting uneasy and was thinking of calling in his mortgage. It was suggested that the business should be turned into a limited company, but Mead insisted that an independent firm of accountants should be employed to ascertain its value, as he was not satisfied with a report prepared by Reece's own accountants. The defendants agreed to make a report, and did so in August, 1903. On that report Mead went on to form the company, and registered it on 26th November of that year. Mead was substantially the only person who put money into the company, and he and Reece were its only directors. The defendants were appointed auditors of the company at an annual fee of 30 guineas. They audited the accounts for 1904, 1905 and 1906, and one of the principal questions in the action was in respect of inaccurate increases which had been made in the stock during those years, as was alleged by a member of the board of directors and an employee, which were not noticed by the auditors.

In 1904 it was made clear to the defendants that a very careful examination of the company's position was required. Reece had been in the habit of paying for all his business requirements by bill; but the company decided it would be better to pay cash, and in order to raise the money thought of issuing debentures. The defendants prepared a balance sheet showing a net profit of £630 on the year's trading and, in consequence of that, the company on 26th September, 1904, issued debentures for £5,000. For 1905 the defendants prepared a balance sheet showing an apparent net profit of £708; and on that the company declared a small dividend. For 1906 they showed a net profit of £744. The amount of stock-in-trade kept increasing, and in August, 1907, the defendants were requested to look specially into the state of the stock in hand and the efficiency of reserves. Thereupon Mr. Ball, of the defendants' firm, went into the affairs himself, and found that there had been falsification of documents and non-disclosure of liabilities, and that extensive frauds had been committed in each year from 1903. The secretary was dismissed, and Reece, who was acting as managing director, was asked for explanations and at once resigned.

It was discovered that the business had been losing money at the rate of £40 a week. The loss on trading was £8,000, and the secretary had suppressed liabilities amounting to £1,184. The secretary confessed his fraud, and the plaintiffs contended that the defendants should have noticed the manifest falsification of the stock sheets. Mr. Ball became managing director, and shortly afterwards was appointed receiver and manager of the company. The business was sold in July, 1908; and in the result the debenture-holders got 9s. 6d. in the £, while creditors and shareholders got nothing.

Sir Edward Clarke then went through a number of items in the stock sheets and other matters, from which he submitted that if the defendants had exercised reasonable care they must have discovered that frauds were being perpetrated.

John Phillips Mead, called by Mr. Holman Gregory, said he was a solicitor practising in the Temple. In 1902 he had advanced £1,200 on mortgage to Reece, and jointly with another person had advanced a further £570. Owing to the difficulty in getting his interest he pressed for an independent inquiry into the affairs of the business. The defendants were instructed to make a report, and in the result the company was formed. The witness then gave evidence as to the history of the company in accordance with Sir E. Clarke's opening statement.

Cross-examined by Sir E. Carson, witness said that he had been connected with Reece since 1901. He had always found him difficult to get money out of, and was not satisfied he was conducting his business in a straightforward way. He had, however, considered Reece a fit man to leave in sole business control of the company. The secretary was a man whom he trusted also, and he did not think that either of them would knowingly make any false statement. He had not stated any suspicions to the defendants. It was true that year by year the auditors had drawn his attention to the great increase that had taken place in the stock; he wondered at the increase, and spoke about it frequently.

Sir Edward Carson said the increase was said to have been as much as would have met the requirements of the whole business for a year.

Witness, continuing, said that the amount of liabilities alleged to have been suppressed by certain persons connected with the company amounted to £1,184.

Mr. James Fabian, a chartered accountant, of Holborn, said he had investigated the plaintiff company's accounts, and had prepared a list of items from the stock sheets, which had been altered by the persons referred to. For instance, one item had been altered from 'one single sponge' to 'one case of sponges, £25'. Some of the altered items were difficult to notice, but there were among them those to which he thought a vigilant auditor would have called the attention of the board.

Lord Alverstone: Of course, sometimes when there is an honest stock-taking such alterations may be made by people taking the stock. (To witness): A prudent man would not have accepted these stock sheets without requiring an explanation as to some of the alterations?

Witness: No; he would have made further inquiries.

Lord Alverstone (to counsel): I shall not assume that the auditors should have counted every plaister and powder, but what I have to remember is that the witness says the auditor, seeing these sheets, should have made reasonable inquiry.

In reply to Sir Edward Carson, Mr. Fabian said he found no errors in the casting of the stock sheets, although the alleged alterations had been made after the sheets were prepared.

Other evidence having been called,

Lord Alverstone called counsel's attention to the fact that the action was brought by the company, that the negligence was alleged in 1906, while the debentures were raised two years previously. That being so, he asked what was the measure of damages.

Sir Edward Clarke said the question was the amount lost between the time the company stopped business and the time the alleged breach of duty occurred.

Lord Alverstone: The company got £5,000 debentures. Where was the damage then?

Sir Edward Clarke: The damages include the loss of the debenture-holders.

Lord Alverstone: The company is not trustee for the debenture-holders. You will have to satisfy me as to what was its financial position when it was wound up. It may be that the company benefited by this rather than lost.

Mr. Charles William Cornish, F.C.A., a member of the defendant firm, stated that he had been concerned with this audit since 1903. The checking of the stock, and the examination of the company's books and vouchers, had been done by his clerks. He wrote the letters drawing attention to the continual increase in stock. There was nothing to arouse suspicion until 1907, and then the inflation of the stock was not found out from the examination of the stock sheets themselves, but because a letter had been received from the secretary of the company stating what had been done.

Cross-examined by Sir Edward Clarke, witness said the stock sheets had not come before him personally; even if they had done so his suspicions would not necessarily have been aroused. He relied, not on the stock sheets, but on the

certificate signed by the managing director and secretary of the company, who, he believed, were honourable men.

Sir Edward Clarke: I suggest to you it was as much your duty to protect the company against the managing director and secretary as against any other person in the company.

The Witness: There must be some limit to an auditor's duty. If we are not to be allowed to rely upon the word of the managing director and secretary, then no entry of any kind in the books can be accepted without investigation.

Lord Alverstone: Of course, if suspicion is aroused, there is no difficulty about it at all; but with regard to the *prima facie* right of an auditor to accept a certificate of a manager, it has been accepted by the Court.

In reply to other questions, the witness said with regard to five items of payment made on the 3rd August, 1904, but which related to 1903, that if he had examined the books personally he would have asked the secretary how the entries came to be out of date. If the secretary had explained that he omitted to enter them in the bill book at the time, he would have considered it a sufficient explanation.

Sir Edward Clarke: But would not you have asked him for invoice and account?

The Witness: As a matter of fact, I should not have had occasion to ask him, because the account was closed when we went through the book in 1904. There was no balance on that account at all.

Sir Edward Clarke: Surely the fact of accounts being entered in wrong order of date in a book of that kind is very suspicious?

The Witness: I do not agree. This man had a great deal of work to do, all the writing work, correspondence, ordering of goods, keeping books. If he had said to me that, in the rush of work, it escaped him making the entries at the time, I should have considered that a reasonable explanation.

Further questioned, the witness said it was not the practice to go behind the last balance sheet. Some limit must be put to an auditor's work, and it was the custom to assume the last balance sheet as correct. Certain green ticks in the private ledger were not put there by himself or his clerks.

In reply to the Lord Chief Justice, witness said that the fact that sales were stationary, while stock was increasing, was not a suspicious circumstance. It was a question of policy for the board as to whether they were buying more than necessary. It might be they had exceptional opportunities of buying at a cheap rate.

Mr. Francis Temple, a clerk in the employ of defendants, said that he had taken part in every audit of the accounts of plaintiffs except those for 1904. The work he had done on the stock sheets of 1905 was to check additions, and compare some of the prices with invoices. Nothing in the stock sheets had aroused his suspicions. In 1907 he had been again instructed to undertake the audit, and had made certain discoveries, which he communicated to Mr. Ball. Thereupon Mr. Ball called on Kingston, the secretary of the company, and afterwards investigated the books himself.

Cross-examined by Sir Edward Clarke, witness said that, in checking stock sheets, he never took any steps to see whether the quantity of the stock was inflated.

Mr. John Ball, F.C.A., said he was the senior partner in the defendant firm. He had nothing to do with this audit previously to 1907. On 19th August of that year his clerk, Temple, had told him he could not agree the balance according to the cash book with the balance as shown in the pass book, and that he had noticed the payment of a large sum in cash. The next day Temple reported seeing some marks or erasures on statements of creditors that had been produced to him in verification of bought ledger balances. Upon this, witness had gone over to the office of the company in Newman Street, and had looked into the question of the cash very carefully. He had found there was no cash missing, but certain statements which Temple had shown him had evidently been altered, and in some of them there were erasures. He had spoken to Kingston, the secretary, and got a plausible explanation which he did not accept. He had communicated with Mr. Mead and Mr. Steele, the company's solicitor, asking permission to communicate direct with the creditors. That permission was given, application was made to the creditors, and when the statements came in to the auditors, they found very serious differences between the figures in the books and the statements

rendered by the creditors. A board meeting was afterwards held, and on the next day Reece resigned. With regard to the stock sheets, the witness said that, being rough originals the alterations would not have excited attention on his part. As to the liabilities that had not been disclosed in 1903, there was nothing in the books by which this suppression could be discovered at the time. In 1907, after Kingston had made his confession, they had naturally scrutinised exceedingly closely any alterations which might have been made in the accounts, and on looking into the original documents in relation to these four items, it seemed they had not been brought into the accounts in 1903. Afterwards, they had found, with regard to one of them, there was a genuine dispute.

Cross-examined by Sir Edward Clarke, he said he had not seen the original documents referred to previously to 1907.

Other witnesses having been called,

Sir Edward Carson said that the points which arose required consideration, but they narrowed down to very small dimensions. The first point was as to negligence. In this respect he left out of consideration entirely the question of the £1,170, because it was not now pretended by the plaintiffs that the auditors might have found out that liability was being suppressed from the 1906 account. There remained the question of the stock sheets and the 1904 account. The only stock sheets which had been proved, as a fact, to have been wrong were those of 1906; and although it was said an inference might be drawn that the others were wrong also, Kingston's confession was only evidence that the totals had been altered, and nobody really knew what was the extent of the default, if anything, as regards inflation of the stocks in 1904 or 1905. Dealing broadly with the stock sheet his lordship was asked to hold that there was negligence, because the auditors had not been led by them to institute inquiries which would have shown the inflation. On both sides witnesses admitted that the ordinary course was to entrust this matter to clerks. Doing these additions, extensions, comparison of summaries, and so on, was clerical work, and if there was nothing to excite the clerk's suspicion, he did not bring the matter before his principal. In this case there was not a particle of evidence that any clerk had his suspicions excited. His lordship might take it that none of the clerks had had their suspicions excited, and consequently the matter had not been brought before the principals. That fact carried them a good deal of the way. All the witnesses called by the other side were principals; they were approaching the case as if they were in the position of men whose attention had been called to these alterations by the clerks. Of course, if that had been done, the principal would at once have asked why the clerk had brought the thing before him at all: but it did not carry the case much further to say that if the matter had been brought before a principal, that principal would have been suspicious. All the witnesses agreed that auditors were entitled to rely upon the certificate of the manager and secretary; in this case he specially pressed that fact because Mr. Reece was the original founder of the business. He was the man who had built up the branches. He had taken one-half of the capital, and was therefore vastly interested in the proper running of the business, and he was the only man connected with the business who thoroughly understood its technical working. The certificate in this case was of a very strong kind; they had the manager's certificate from each shop, and these again were certified by Reece and Kingston. And Reece did not merely certify that the stock sheets were correct, but said that he, or he and Kingston, had inspected this stock, gone through it, and found that all was there and in saleable condition on these particular dates. It would be impossible to carry on any audit at all if the auditor was to suspect everybody without any grounds of suspicion being put before him. Really, therefore, as regarded the stock sheets, the question was this: Ought those clerks, having found everything correct as regarded additions and extensions, and having called for invoices to check the prices put down, and not being bound or in anywise in a position to check the amounts—ought they to have been suspicious of something wrong in the fact of the certificate of the manager and the secretary, simply because they saw these alterations? In stock sheets, where the person compiling them has to go about from one part of the premises to another, collecting from here, there, and everywhere, if he finds a parcel of goods in one place and another parcel of the same sort in another place, he does not make two separate entries—

Lord Alverstone: Sir Edward Clarke does not deny that. He suggests to you that the character and kind of the entries goes beyond that.

Sir Edward Carson replied that the suggestion was easy to make, but here were experienced clerks, and their suspicions were not aroused. It had been said that these auditors did very little. He hoped his lordship would not come to that conclusion. The correspondence showed that the one matter which could have aroused any interest in an auditor, not as regarded dishonesty, but as regarded the way in which the business was being conducted, i.e. the vast accumulation of stocks, considering the small business done, was a matter which the auditors brought before the directors in every report from beginning to end. In 1905 they pointed out in their report that the company had then on hand very nearly a year's stock, having regard to the amount of sales which were being made, and they asked that the certificate should be qualified or some materials be kept by which they could check the amount of goods going out, because it was impossible for them to check the amount of goods, especially at the head warehouse. This accumulation of stock was one of the things which caused concern to the directors when, in 1907, they called for a special audit to be made; but the auditors had been pointing it out from 1905. The request made by the auditors in 1905 was not acceded to, but the fact that they made it showed that they were not performing any duty in a perfunctory manner, but were attempting to deal with the situation which had arisen by drawing the attention of the directors to a fact which turned out a cardinal fact in the end. He contended that, as regarded all these matters, the auditors had exercised ordinary and reasonable care in carrying out their duties. The other matter which arose was as to the four items. These items did not appear in the 1903 accounts at all, and whether the auditors were liable for them was the question which had to be tried in the Mead action. It could not come into this action. Therefore, when in 1904 they came to audit, all they had done was to allow into the balance sheet items which had not been in the 1903 accounts. It was not disputed that these items were really paid in the year they were certified, and the sole charge was that the auditors, having found these items were paid in respect of goods ordered and supplied in the previous year, did not specially report that matter to the directors. As a witness had said, it would be impossible for many reasons to do that; items like that occurred over and over again, and here, at all events, it was a fact that these items had not appeared in any previous accounts.

Lord Alverstone: I do not think Sir Edward Clarke disputes that. But he said it was your duty, as auditors, to draw the attention of the directors to the fact that in these outgoings for 1904 they had, in fact, paid liabilities that ought to have been called to their attention at the end of 1903.

Sir Edward Carson: I understand that is what he suggests. But your lordship sees you would have first to say in that case that it was their duty to sit down and examine what had been included in the schedule of liabilities. My lord, nobody had said they ought to have done that.

Lord Alverstone: They are entitled to take the liabilities of 1903 as a total sum?

Sir Edward Carson: Yes.

Continuing his argument, the learned counsel said that all these were payments that were made by the directors themselves. Mr. Reece certainly knew of them and Mr. Mead was a party to them and, as regarded the Haskins case, the account was actually brought two or three times before the board with a view to a settlement of the matter, and was paid by them. He could have understood the charge if it had been alleged that the money had been really paid in 1902 or 1903, and the accounts had been cooked in some way so that an employee had kept the money for himself and had then charged it to the next account. As to the way in which an auditor might be satisfied by vouching, there were many ways. But certainly, if payments were made by bills, and the auditor asked to see the bills, that would be the very best way.

Lord Alverstone: Take the case of a bill sent in twice. It might be that it would not be right to assume, particularly if the goods were supplied before, that that bill was not included in an outstanding liability as on the 3rd August, 1903.

Sir Edward Carson replied that if that were so an auditor would have to go

through every item to test if it really occurred after the date of the previous audit. All were agreed that, whatever was being done with these moneys, they were not being in anywise purloined. When an auditor had traced a charge through the cash book and bank book, and was satisfied that all had been honestly done, he had done all that was essential to the company in the way of seeing it was not being cheated. In this case there was no special circumstance which would in the slightest degree lead the auditors to suspect that what was being done was not perfectly bona fide and in the ordinary course of the business of dealing with accounts that came in during the year and were discharged. There were two things which his lordship would have to consider. The first was as to whether there was any suspicion; it was quite clear there was no suspicion. The second point was, ought there to have been any suspicion? In a case where there was no evidence of a single penny being taken out of the coffers of the company, what were the auditors to be suspicious of? Supposing they had a suspicion of something, what ought they to have done? Supposing they had had a suspicion, on seeing the stock sheets, all they could have done would have been to go to the managing director—who was the owner of half of the capital of the company—and say, 'Why are these alterations here? We see you have certified them as all right; we find the balances and everything right. But why are the alterations here?' It suggested that Mr. Reece having certified these stock sheets, would or could have given any information which could have led to any result? The only other matter upon this branch of the case which he wished to say anything upon was this; an auditor, it had been said, in these cases, was not bound to be suspicious—

Lord Alverstone: I think Lord Justice Lindley went further, and said he ought not to be suspicious.*

Sir Edward Carson: I suppose you could not carry on business at all if you were suspicious. And another thing, he is not to be a detective. These statements especially applied in a case like this.

Continuing, counsel said that no case had ever laid down that an auditor was not entitled to accept what a managing director had certified, and no case had gone the length that had been attempted here, of suggesting that the principal would be liable if the clerk had done something in the ordinary course of his duty, and by reason of that fact a matter had not been brought to the notice of the principal. On the question of damages, if something had been done which had prevented the company getting its debentures, a claim might have been made; but how could it be suggested that a company was injured because the inflation of a balance sheet had led to its getting more money than it otherwise would have done? This money being supplied gave them the chance to go on and make the business a very great success; although, certainly, this possibility was not realised. The only way in which the case might be put would be to say that, if the stocks had been rightly returned in 1904, 1905 and 1906, the business would not have been gone on with, and for that reason the plaintiffs would have been in a better position. But that was exactly what Lord Justice Vaughan Williams had said was too remote a case of damages. In the present case no one had attempted to estimate what would have been the relative position of the company in any of those three years if a liquidator had been appointed then, as compared with 1907. Apart from the question of remoteness, it would be utterly impossible to assess the amount of damage. His last point was that under the articles of association the auditors were officers of the company. Under the misfeasance sections of the Companies Acts, auditors had been held liable as being officers of the company they served, and in the *Kingston Cotton Mills* case, where the articles were exactly the same as here, the auditors had been held to be officers of the company. He submitted, in conclusion, that there had been no negligence, that no damage had been shown, and that the auditors were protected by the provisions of the articles of association.

Sir Edward Clarke spoke at length on the question of whether the auditors were protected by being officers of the company. The decisions which held that they were for purposes of misfeasance required to be carefully looked at, and

* The words of Lindley, L.J., were 'I protest however against the notion that an auditor is bound to be suspicious, as distinguished from being reasonably careful.' The famous 'watch-dog' dictum was uttered by Lopes, L.J., in the same case (*Kingston Cotton Mills*).—Ed.

would be then found not to apply to a case of this kind. Auditors had been in those cases held to be officers, for the public reason that it was essential some means should exist of making an auditor responsible for misconduct. The articles did not protect the auditors from the consequences of negligence; if an article did say that they should not be so responsible it would be illegal and therefore null and void. The officers who were protected were the executive officers, who were appointed and were removable by the directors. Turning to the facts, nothing was to be gained by quoting passages here and there from Lord Justice Lindley's case, because, however carefully expressed, they were balanced passages. He understood the ruling in that case to be that auditors accepted for reward a particular position, the duties of which were laid down by statute. They were so employed because they professed to bring to the discharge of these duties a trained capacity for dealing with such matters. They were bound to bring that capacity to bear upon the execution of those duties, together with fair and reasonable industry. If they were found negligent in the discharge of their duty, and mischief resulted, they would be liable in damages. Before dealing with specific facts there were two observations which he wished to make. Sir Edward Carson had said it was a common practice for accountants who were auditors of a company not themselves to inspect stock sheets—

Lord Alverstone: I have thought a great deal about that, and I am not with Sir Edward Carson. It seems to me the same standard is due both from the man who is sent as from the man himself. I do not, with a very slight modification perhaps, agree that if Mr. Cornish's suspicions ought to have been aroused it is any answer to say that Temple's suspicions were not aroused.

Sir Edward Clarke: The auditor is retained to do his duty; if he chooses to delegate that duty to somebody else he is responsible.

Continuing, counsel said that his learned friend had stated that from time to time the auditors had called the attention of the directors to the fact that the stock on the new balance sheet appeared to be excessive as compared with the stock of the previous year. They pointed this out, and said they relied for valuation of stock upon the statements of the manager and secretary. It was true this would be found in their letters. They also pointed out that especially with regard to the proprietary stock they had no means of testing its value, and he agreed that was so. But it was not on the question of valuation of stock that he attacked these auditors. It was that under their eyes there was growing up year by year an abnormal figure. It was clear upon the accounts that there was something which required investigation. With this large increase in the amount of stock appearing on these balance sheets it was evident that either there was an enormous and curious increase in the stock itself, or, which was quite a reasonable hypothesis, and one they ought to have contemplated, the stock sheets were not trustworthy. They might not have noticed this in the first year, but the fact that they went on year after year with this sort of thing growing up before their eyes, without ever once looking at the sheets from which they might have discovered the explanation of the growth of this amount, was conclusive evidence of negligence. There was a prima facie case of negligence upon the balance sheet that his lordship had before him under date 14th October, 1907. There was an item there of stock £4,334, instead of an amount which, beginning four years before with £6,862, had grown from that to £8,700, from that to £10,400, from that to £11,700, and even a larger amount than that. On the same page were two items which, taken together, were strong prima facie evidence of negligence against the defendants: 'Creditors' claims suppressed by Kingston on the 5th August, 1906, £1,184', and 'Debit balance at profit and loss for year to 5th August, 1907, consisting to a large extent of loss incurred before the 5th August, 1906, concealed by L. H. Kingston by means of inflating the stock, £8,191'. That balance sheet was dated October, 1907; the result of the intelligent and diligent audit of this firm of accountants during three of four years was that under their very eyes there had grown up by alteration of stock sheets this £8,191 of deficiency. And whatever the materials which had been placed before them, they had had the opportunity of making any inquiry they chose during all this time.

In the year 1904 they were employed to make a specially careful investigation of the position of the company, because, with the abandonment of the practice

of paying by bill and resorting to the more economical practice of paying by cash, it had been determined, if the position of the company entitled them so to do, to issue debentures. On the 27th August of that year they had sent in a preliminary report on the accounts, which contained two passages which he thought important. One did not refer to the stock; it related to an item of £53 16s. 5d. for certain liabilities of the vendor which had not appeared in the balance sheet of 1903. The other related to the increases in the valuation of stock: 'The increase from 1903 to 1904 chiefly occurs in the stock at the warehouse, which in 1904 is £4,048, as compared with £2,435'. So the stock in that warehouse had been increased about 66 per cent. in the one year. This report was sent on the 27th August, and on the 1st September there was a notable interview between Mr. Mead, Mr. Steele and Mr. Cornish with regard to the investigation which was then going to be fully made, and Mr. Cornish was told the company contemplated issuing debentures. At that time—as stated in their report—they had not the certified details of the stock before them, but the stock sheets were sent in a letter of 2nd September. Those stock sheets never came before the eyes of any one principal of the defendant firm; they were never seen by anybody but Mr. Temple and two other clerks. Mr. Cornish had gone away for his holiday before they were received. The figures in the stock sheets were corrected by the clerks. Mr. Cornish wrote from Sheringham, 'With regard to the corrections found in the stock sheets, please write to the secretary returning the summary, pointing out the corrections', and there the matter of the stock sheets ended, although later Mr. Cornish made a claim on behalf of the firm for an increased payment on account of the extra labour that had been expended in making the investigation of these documents. On the 6th October he wrote, 'The stock lists are very voluminous, but we have examined and tested these as far as we have been able'. The statement was not correct; in fact, they had never been tested at all. If they had been tested what would have been found out? One witness, Mr. Kelleway, had been called as an accountant to support the defendants. He had been asked, supposing he had noticed that the alterations in the stock sheets were not casual blunders, now one way and now another, but that they substantially inflated the stock in the aggregate, would not that have put him upon inquiry, and had replied, 'Yes, I should have inquired'. If the defendants did not find out about the stock sheets, and therefore did not inquire, it was their fault; for these stock sheets were amongst the most important vouchers supplied to them in connection with the business.

There was another observation of Mr. Kelleway. Asked if the rough stock sheets were not safer, he had replied, Yes. The defendants had the rough stock sheets under their eyes; they had also under the Act of Parliament all the books and vouchers of the company at their disposal. It was not for them, after four years of disastrous trading, to come before the Court and say they had never looked at these most important documents. If they had looked—if any reasonable man with any sort of equipment as an accountant had looked, he must have noticed some, at all events, of the items which had been brought to his lordship's attention. That would have put him upon inquiry as to the truth of the items which he was called upon to accept. His learned friend had made a comment on this. He had said, What could they do, suppose they did find them? They would have had to ask Mr. Kingston or Mr. Reece, and in either case they would have been asking somebody who, being himself responsible for the fault they were trying to detect, would, by his assurances, have met their inquiries. But it would have been no fulfilment of their duty merely to have asked a question of Mr. Kingston or Mr. Reece. When the auditors saw the stock sheets in 1904 they ought in the first place to have found out some of the spurious items. He did not say all; but if they had only found two or three out of the forty items which had been submitted to his lordship, they would have been impelled to look further. If on the second page two or three more such had been found they would have gone on to look carefully through the whole, and would have found again and again an interpolated entry with a very considerable sum attached to it, and alterations which must have put them upon inquiry. They would have made inquiries; and whatever answer they got, they should have told the company itself that this had happened, and that they had been called upon to make inquiries with regard to the matter. Had such a communication been made to the company in 1904 the debentures would not have been issued.

With regard to the omitted liabilities, it had been suggested that auditors examining a balance sheet were entitled to look to the previous balance sheet as being a document on which they might rely, that whether it was their own or anybody else's they were not called upon to go behind it. But when this balance sheet was drawn up in August, 1904, Mr. Cornish knew perfectly well that from August, 1903, Reece had started a fresh set of books which were described and suggested by Messrs. Baker and Cornish themselves, opened by them, and charged for at a fee of £9 9s. Amongst these books was a private ledger, in which there was an amount put down for liabilities; and that it was present to Mr. Cornish's mind that he had to look out for liabilities which were not properly charged against the company was shown in the letter of 27th August, 1904, where he said there were £53 of liabilities of Reece which did not appear in the balance sheet of 3rd August. The entry in the private ledger should have brought to their mind the amount of the liabilities which should have passed to the company. It was clear they had seen this book; at all events, they were entitled to ask for it.

Lord Alverstone: I think Mr. Greenstreet was extremely fair about it. He said: 'No doubt I saw that book; there are entries I made in passing'.

Sir Edward Clarke said the book being seen carried them to a total amount of liabilities at August, 1903. Directly Mr. Ball addressed himself personally to the investigation of these accounts in 1907, before any accounts had been obtained for the firms dealing with the company, he discovered four accounts, amounting to about £500, which on the 10th October had been omitted from the liabilities. The question was whether the auditors ought not to have found that out in 1904. It was a very material thing for them to have found out. It was true the agreement was to take over the concern as from the 3rd August, but it was taken over on the basis of the balance sheet which they themselves had prepared—

Sir Edward Carson: You have no right to say that.

Sir Edward Clarke: I say it.

Lord Alverstone: Never mind. On the basis, say, of the 1903 balance sheet.

Sir Edward Clarke, continuing, said the accounts were taken over as current accounts as from the 3rd August, 1903, being taken over on the basis of the balance sheet, and the auditors dealing with the first year of a business, which might or might not be liable as between the company and the vendor in respect of certain things which had been incurred before 1903, ought surely to have checked and obtained vouchers for amounts—especially amounts which were shown to have been paid out during the very early part of that year. In Haycroft's case, for example, where the amount was £48 3s. 4d., the auditors had before them the bought ledger; they had before them the bills payable book. In each of those two books they would find entries with regard to Haycroft made before their account was made out—considerable sums of money paid out of the company's cash to Haycroft in excess of the amount which the company had taken over as a liability. It could never have been suggested to them that these were new liabilities incurred subsequently to the 3rd August, because the date of the entry which referred to these amounts was actually the 4th August, the very day after the transfer of the business. They were in this position, that the books before them showed when looked at that, whereas on the 3rd August, 1903, the liability was taken at £48 3s. 4d., on the very day after the beginning of the account, £311 owed had been paid in bills, entered in the books, and in each case—both in the case of Haycroft's account and in the case of the bills payable book—entered at that date. One witness had said that if he had seen that he would not have paid attention to it, because the secretary had a great deal to do, and might make a mistake and not enter those bills. Was not that a ludicrous explanation? The secretary was supposed on the very first day of his dealing with the accounts of the new company to have paid out bills in respect of an item exceeding by six times the amount of the liability which had appeared on the balance sheet of the day before.

Lord Alverstone: I do not know that it matters. I see your argument, but it is a little overstated. There is only one bill on the 4th; all the others are on the 24th. I do not see any difference. You cross-examined the auditors about the next month, but I should think they ought to be equally careful about any payment made in the course of that year.

Sir Edward Clarke: I am not minimising the care they ought to give to every payment; but I think it strange that immediately after the exchange is made on the basis of this £48 3s. 4d. being owing the man gives bills on the 24th August, and is supposed to forget them, and to forget to enter them in the bills payable book and the ledger—in the one case until after July of the following year, and in the case of the ledger until after February.

Continuing, the learned counsel said he had himself taken out some figures from the books which would show that it ought to have been obvious to defendants that there had been an inflation of stock, not really an increase of stock. Purchases were in 1903 £8,275, in 1904 they were £9,148, in 1905 £8,159 and in 1906 £7,856. That showed purchases were diminishing. Sales were diminishing also. In 1903 they were £13,457, in 1904 £13,437, in 1905 £13,097 and in 1906 £12,564. But with diminishing purchases and sales stock was increasing. In 1903 the increase was £1,300, in 1904 it was £1,897, in 1905 £1,750 and in 1906 £1,170. It had been suggested that the wages affected this; but there was no increase of wages which would account for stock being manufactured and brought into the account. Wages in 1903 were £2,316, in 1904 they were £2,175, in 1905 £2,340, and in 1906 £2,271. These were figures which, seen by an accountant from year to year, ought to have shown him conclusively that this was not a real accretion of stock, but must be an inflation of the figures by which that stock was represented. It was a state of things which in 1904 would be surprising; in 1905 it would be suspicious; in 1906 it must surely have amounted almost to demonstration that there was a fraudulent tampering with the stock sheets. The stock had begun as £6,826, when it was taken in 1907 it came to £4,334; that was a difference of £2,500. If to this latter figure they added the £1,300, £1,897, £1,750 and £1,170 the total was £8,200, almost exactly the figure which was shown upon the balance sheet of 14th October, 1907. Really the whole losses of the company during this time had been accounted for by that figure. One other observation he would make before leaving the subject. The alterations in the stock sheet of 1906 were so recklessly made that Sir Edward Carson had said that if anyone had seen them he would have been put off the idea of fraud, and been led to think it must be mere carelessness or stupidity. Really, if those stock sheets had been examined by anyone used to accounts it would have been impossible for him to escape seeing they had been inflated to a remarkable degree. The learned counsel then addressed himself to the question of damages. In consequence of the negligence of the auditors dividends had been paid of £200 in 1905 and £315 in 1906. Beyond this the company had been led to raise £5,000 on debentures. Upon the £5,000 so borrowed it had paid 9s. 6d. in the £. It had discharged its obligations so far as it could by realising all its assets; but it had not been wound up, and remained under a liability of about £2,500.

The evidence was then heard in the second case.

Mr. Mead retold the story of his advancing money to Reece, and of the formation of the company. Mr. John Harmar Steele, who had acted as Mr. Mead's solicitor in the transactions, gave evidence on the same subject. He had believed both Reece and Kingston to be honourable men. He thought Reece's difficulties were entirely due to want of capital. At the time when Mr. Mead had advanced money, witness had believed the business was genuine and could be developed into a good thing. Other witnesses for the plaintiffs repeated or confirmed evidence as to the stock sheets, &c., which had been given in the previous case.

For the defence, Mr. Cornish was again called, with Mr. Ross, Mr. Temple and others, in rebuttal of the charges of negligence; their evidence being necessarily very similar to that which had been given in the previous case.

The evidence being concluded,

Sir Edward Carson said he would respectfully submit that in this case there was no shadow of evidence of negligence. What had come out in cross-examination as to labels? The witness was to find out anything he could by going through the accounts which would raise suspicion. As the witness knew, when doing this, that something had happened, it would be the most unfair way in the world to judge auditors or any other professional men. His lordship had been asking as to the stock sheets whether any inquiry had been made of district managers and sub-managers. The reason no such inquiry had been made was that nobody had, from the beginning to end, thrown any doubt on the honesty of the sub-managers.

Mr. Mead, himself a director of the company, brought into contact with them, had the best means of finding out.

Lord Alverstone: That is not the only point. I have got to be satisfied on the earlier years, 1903 and 1904, that the stock was not there?

Sir Edward Carson replied that there was no evidence that the stock was not there in 1903, except Kingston's statement that he began falsifying the accounts at an earlier date.

Lord Alverstone: Everybody agrees that up to a certain time there was no possible reason for mistrusting either Kingston or Reece—according to Mr. Mead, up to 1906 or 1907. You have yourself given evidence that the suppression of the four accounts in 1903 was some evidence of misconduct by Kingston at that time. That is the only evidence that he was fraudulently inclined then. Of course, Sir Edward Clarke's case is that he was fraudulent long before, but I have got to consider what the evidence is about it.

Sir Edward Carson: He says Kingston was fraudulent all through. But here your lordship is asked with regard to these stock sheets to say there were fraudulent entries upon them, or something which looked like fraudulent entries. All they had to do to prove that was to go to any one of these managers—for anything I know they are still in the same shops—and say to them, 'What about this change? Was your certificate put on before or after that?' But instead of doing that, they have been asking your lordship for the last two days to go through a kind of analysis of these various books—the very thing which Lord Justice Kaye said was not to be done.

The learned counsel, continuing his argument, said that on the question of the outstanding liabilities no book had been produced, or could have been produced, before the auditors which would have shown them anything with reference to the accounts except what they had returned as being the true state of affairs. One of the witnesses for the plaintiffs, Mr. Fabian, had his mind so full of the incompetence of the defendants, and his own better system, that he had actually taken a closed account of a bill in the book, and said that an auditor of his cleverness, even though he suspected nothing, would have inferred from the closed account that there was an account open. If that was out of the question, as it was, what remained in this case? Sir Edward Clarke had tried to prop it up by saying there was some extra duty by reason of the fact that there was money outstanding. He ventured to submit that in all cases, what an auditor was bound to bring was reasonable skill and care, and, as to the degree of such skill and care, there was no higher degree or lower in the case of the shareholders or of the intending purchaser. Towards the end of this case, Sir Edward Clarke had been so pressed that he had attempted to cross-examine as to whether the creditors ought to have been sent to for statements. But not even Mr. Fabian could screw himself up to saying that the creditors ought to have been asked for statements without special directions and some reasons being given. He would ask his lordship to approach this case with the belief that auditors have the right to believe a man honest until they have something on which to rest a suspicion of dishonesty. Their business could not be carried on unless they could accept books as honest until they found something either in the men or in the books to show they were dishonest. There was nothing of the kind in this case. It was a matter of very great importance, and he asked his lordship to say that his clients had exercised the reasonable skill and care which was their duty, and had discharged the whole duty which lay upon them towards their clients.

Sir Edward Clarke: There are two matters in which this case now before your lordship differs from the other. It is different in the position of the defendants in relation to the person who is suing them upon the contract. I shall ask your lordship to reconsider the opinion which I think has been expressed, namely, that the duties are upon the same level.

Lord Alverstone: I was not putting it against you. I was only saying that, in the company's case, I should put the duty as high as in the purchaser's case. What I meant was that I did not propose to assume a less standard of duty in the one case than in the other.

Sir Edward Clarke: I am much obliged to your lordship for saying that. What I point out here is that when my learned friend has been trying to interweave

with his arguments in this case the considerations which apply to the auditors of a company, I think that he is, for the moment at all events, disregarding the essential difference between the two cases. Where the auditors are advising a company, and are invited to rely upon, and do rely upon, the statements of the manager or secretary or other official, they are relying upon the statements of persons employed by the company to which they are reporting, and who are presumably trusted by the company in the sense that they are trusted by the persons who are authorised to carry on the responsible business of that company; but, in the case where accountants are called in to advise a person who is intending to put money into a business or purchase a business, the persons who are carrying on the business are not his servants, trusted by him, but they are the persons in respect of whose conduct in relation to him he has to be guarded by the advice he is seeking.

Lord Alverstone: Nobody suspected Reece. He was advancing money through Mr. Steele, and Mr. Steele says he believed Reece to be perfectly honest, and that his only difficulty was due to low capital.

Sir Edward Clarke replied that, in this transaction, Mr. Mead was at arm's length with Reece and Reece's servants, with opposite interests in this investigation. In a letter of the 9th May, 1903, the defendants were put upon notice of this fact—quite apart from what had been communicated to them in the interview to which Mr. Steele had spoken. The letter said: 'You will please bear in mind that the report is primarily required to satisfy Mr. Mead, the mortgagee, that the business is conducted upon business principles, and that the accounts of assets and liabilities fairly show the state of the business'. A witness called for the defence had put the exact case which was now before his lordship. It was the case of a person going to buy a business, and requiring to be advised, not as to the contents of books which had been kept by the persons who were carrying on the business, but as to the real condition of that business and of the amount of liabilities and assets which he would be taking over. The duty of the defendants was not to accept the statements of the vendor or his manager and clerks, but to test those statements in order to protect Mr. Mead; and, that being the case, they had done nothing whatever that could not have been done by a board school scholar who had learned arithmetic. The important things which appeared on the accounts were really the question of the liabilities and the question of the stock. With regard to the liabilities, what they did was to receive a list of liabilities from Kingston, and then they employed a clerk—the principals did not seem to have taken any very active part in it themselves—to do what? To see that the figures which had been entered in the list corresponded with the figures which appeared in the books. Of course, that was no check at all. A man intending to be dishonest would not hand to the auditors a list of accounts, the dishonesty of which would be detected the moment they turned to the books. It was no test of honesty, only of accuracy. He had asked Mr. Jenks, 'Would you be content with that?' 'No,' he said, 'in the case of a purchaser I would not.' 'What would you do? What could you do?' 'I would ask for the creditors' statements.' His learned friend was under quite a misapprehension when he said it had been suggested the creditors should be written to for their statements. It was not suggested that any accountant would, in the ordinary course of his work, write to the creditors of an existing and continuing business to ask them to make special statements. But in any current business at any moment there were upon the files in the place the latest statements that had been supplied and receipted by the firms which were dealing with this business, and these statements could always be asked for. The responsibility in this matter had been handed down from one to another. Mr. Cornish was on a holiday at Sheringham, and left the matter to Mr. Ross, who did the work through Temple. Temple was the man who had been really employed upon this. He had been asked with regard to that list of liabilities. He said, 'I checked it with the books, and it agreed with the books.' Asked if he did anything else but check, he could not tell of a single item in that list with regard to which he had made inquiry. He had said generally that he made inquiry with regard to some of them, but could not state in the witness-box that he had asked a question with regard to any one except the item of Haskins with the £25 receipt. This was the only one he would pledge his oath to having seen, and it was a curious thing that

this was one which told him upon the face of it that there was something wrong in the statement that had been made to him. He had seen this receipt for £25, and upon the document which carried the receipt was a statement that a sum of £69 more than had been put into the list was claimed by Haskins. What did he do then, this auditor who was to protect Mr. Mead against anything which would be dishonest or deceitful on the part of Reece and Kingston? He asked Kingston what was the explanation. Kingston replied, 'Oh, it had been agreed at a lower figure.' And without one fraction of evidence that this was true, Mr. Temple accepted the statement and passed the list. If ever there was a case in which the accountants had absolutely failed to discharge any duty that they owed to their employer, it was in the present one. Temple was the firm, for the purposes of this case, and Temple, looking to one of the items, found that item a suspicious one, an item in which the amount was put lower than it ought to be, and he contented himself with asking Kingston—the very man who, if there was any deceit or fraud, would be the man perpetrating the fraud. It was not true that any such agreement had been made.

Sir Edward Carson: You have not proved that.

Sir Edward Clarke: It is not true, and that is proved by the subsequent proceedings in the case. If there had been any such agreement the sums which were afterwards paid in respect of this would not have been paid.

Continuing his argument, the learned counsel said that the auditor was bound to verify Kingston's statement. When Kingston told him an agreement had been made whereby he was entitled to include in his list of liabilities an amount which was £70 less than should have been there, the auditor was bound to ask who had made the agreement, when it was made, and where it was. But Temple never made any inquiry at all. If Mr. Mead had been told that Kingston had been making a statement which had been checked and found incorrect, he would have been put upon suspicion with regard to the honesty of these figures—a suspicion which, as he submitted, the auditors ought to have entertained when they found a thing like this occurring. It was not as if this had been one of many matters which had been inquired into, and this the only one that had been found incorrect; but this was the only item with regard to which Temple would pledge himself that he saw a statement or asked for a voucher, and it was one which ought to have put him upon inquiry. Passing over the balance sheet in which these items should have been carried in on one side or other—they would certainly have reduced the profit of the year by £169, or something of the kind, the real point was that Mr. Mead should have been advised by the auditors that they had found they could not get vouchers for the items which represented liabilities he was undertaking, and that would have put him at once in such a position that he would have declined to go on and purchase a business with regard to which there were matters of this kind.

If that were so with regard to the liabilities, the case was even stronger with regard to the stock and with regard to the labels. Their own letters showed that their attention was attracted to the very considerable increase of stock as shown on the accounts. They asked for an explanation, and one was given which might be considered reasonable as regarded part of the amount. But surely if they had asked about the increase of stock at Kentish Town, knowing that it had all been dealt with, they would have prevented a misleading inference being drawn that sufficient profit was being made there to warrant continued negotiations being made for the purchase. With regard to labels, there was a letter which showed that the accountants' attention was called to it, in which they stated that the increase in the quantity of labels at the warehouse—from £335 worth to £475 worth—was because labels which had been previously included in the stock at the branches had been transferred to the warehouse, as all medicines made by the firm were now made there. It was the duty of the accountants to test the explanation that had been given for this very serious item. Anybody who had addressed himself to this question with ordinary diligence and ordinary intelligence would have looked at the stock sheets. He would have then found that at the warehouse the item of labels was increased from £335 to £475. The explanation of this being that it was due to the withdrawal of labels from the branches, he would have looked at the stock sheets of the branches. Had he done this with ordinary

care, he would have seen that there were certain items, apparently bona fide items, such as would in ordinary course be included, viz. 7,000 labels at 10d., and so on, carried out, and always carried out to amounts which were less than £2. £1 18s. was the largest of these detailed items in the balance sheet. He would then have noticed that somebody had put into those stock sheets items which, as applied to labels, were absolutely ridiculous. An item of £35, as applied to labels, taking them at such prices as were shown in the detailed estimate, would mean hundreds of thousands of labels, for the presence of which at the branches no conceivable explanation could ever have been offered, while their presence at the branches and in the stock sheets of those branches was utterly irreconcilable with the statement that the stock had been moved from the branches to the warehouse. The first duty of these accountants was to look at the stock sheets and to look at the item to which, obviously, by their own statement their attention had been called; and to endeavour to ascertain the truth with regard to that. If they had done so they would have come upon this series of items—£20, £20, £35 and so on, which would represent a preposterous number of labels, and were entirely different from the other sort of items. The total amount of labels on the branch sheets was over £200; and this, added to the £475 for labels at the warehouse, would inflate the item beyond all possible reason. The importance of it was that any auditor detecting these items and asking for an explanation would be bound to get information as to the number of labels which there were in fact; and would have pointed out to his client that these sheets were unreliable. When defendants were assuring Mr. Mead that he would be justified in dealing with this business on the basis that there were so many thousands of pounds' worth of stock at the warehouse and the branches which would be security for any moneys advanced, they were assuring him of that which they did not know and which they had taken no means whatever of checking. In these circumstances he asked for damages. There would be no difficulty in assessing the amount. £3,000 was the amount which his client had lost by the default of the accountants, and he asked his lordship to give judgment for that amount.

JUDGMENT

LORD ALVERSTONE: These two cases have been before me for the best part of four days, and I do not wish to conceal the fact from anybody that I have spent a great many hours out of Court in dealing with them. I have had the very greatest assistance from the eminent counsel before me, and I must of necessity deal with a great deal of detail. It must not be thought, if I do not happen to refer to every one of the minute points to which my attention has been called, that I have not considered them; and, inasmuch as there is no jury here, and my findings may be considered, I only trust that those who may criticise them hereafter will not suggest or think that because I do not note a particular thing it has not passed through my mind. I will only endeavour to give such reasons as I can for the judgment I have formed to enable those who review my decision to understand the grounds upon which it proceeds, and, of course, if they are wrong I can be corrected. I only hope that I shall not be corrected for grounds which I have not considered or thought of sufficient importance to mention them myself.

The case is one of very great importance, because it raises in a very distinct way the question of what is the obligation of accountants who are instructed to advise either an individual or a company with reference to the condition of business of a going concern. I propose to take Mead's action first, not that in any way to my mind it differs from the other in principle, but because it is suggested by Sir Edward Clarke that a higher standard of duty is required from the defendants. If that is right, and if I come to the conclusion that there is no breach of the higher standard of duty, I shall have less difficulty in dealing with the case, where, according to him, there is a lower standard of duty; but I myself have not been able to recognise the distinction. I think in both cases Messrs. Ball & Co. were in this position, that if, by the exercise of reasonable care, they would have sent in a different balance sheet, or would have cautioned their client in regard to the items in the balance sheet, they would be liable for damages in this action; therefore I do not draw any distinction between the two cases. The other reason why I propose to take this action first is because, historically and chronologically,

it is the commencement of the story, and a good deal of that which I have to refer to in Mead's case can be dealt with in the other case afterwards in shorter terms.

I have already stated—I will refer to the authorities in a moment—my view of the obligation of these accountants. I think it only right to say, as so much distinction has been drawn, that a little too much has been made of what is supposed to be the non-connection of Mr. Mead with this business before these accountants were consulted at all. He had advanced £1,200 on mortgage. He was receiving a high rate of interest, 12½ per cent. I attach no importance to that; he is equally entitled to be protected, but it does seem to me that it has a bearing on the confidence which Mr. Mead had in the people with whom he was dealing. Having regard to certain evidence that was given me by Mr. Steele I have not the slightest doubt, and so far as a finding of fact goes, I find as a fact that Mr. Mead never had the slightest suspicion of either of these gentlemen until probably the middle of 1907. He has said himself that he asked questions, most pertinent questions, of Reece and to a certain extent of Kingston. He acted on the board with Reece for, practically speaking, four years. He and Reece were partners in this business, the company was only a two-man company. Reece was the vendor, Mr. Mead was the holder of the 3,000 shares; and it is only doing justice to Mr. Mead to say that he was innocently and completely misled by what he believed to be the way in which Reece and Kingston were carrying on this business. At what stage Reece became a scoundrel—if I may use that expression—became fraudulent, or at what stage Kingston became fraudulent, I am not able to judge. The plaintiffs, having it in their power to give me very material evidence upon these matters, have advisedly, or for some reason which I cannot gauge, abstained from giving that evidence. There are a number of witnesses, who could have been called to support the plaintiffs' case, who could have given the Court most material evidence with regard to the allegations upon which the charge of negligence is made.

But I dismiss all those considerations from my mind and I approach this case of the action of Mr. Mead from the point of view that he was employing the defendants' firm to guard his interests against a vendor who might be putting upon him too flourishing and glowing an account of what his business was—an honest vendor, so far as Mr. Mead believed. It is not suggested that at any stage of which I am now speaking—the years 1903 and 1904—he cautioned Messrs. Ball & Co. against either Reece or Kingston; and it is very material, in order that we may try and put ourselves in the position of what that of reasonable men would be, and see whether or not Mr. Fabian, Mr. Dicksee and Mr. Caesar's criticisms were well-founded or not, that we try and put ourselves in the position of everybody in the years 1903, 1904, 1905 and 1906. It is not immaterial to observe that Mr. Steele, an experienced solicitor whom I implicitly believe, told me in the box that he believed Reece had been very successful, that he had established very successful shops, that he was doing extremely well; and he pointedly put it twice that all Reece's difficulties arose from not having capital enough. Not that he could not make the profit or turnover necessary or that he was charging prices which could not pay; but he had to buy in a dear market and give bills, and was constantly worried by those bills. Mr. Steele attributed all Reece's difficulties to want of capital. If that was true Mr. Mead was entering into a very good thing indeed. He was quite entitled to; a solicitor is entitled to make 12 per cent. as much as any other man. I am endeavouring to steel my mind as much as possible against every possible suggestion that Mr. Mead was not entitled to be protected.

Under those circumstances I think it will be wise to attempt for a very few minutes to examine what the standard of duty is. Fortunately for me in this Court the principles have been laid down so clearly in a germane case with germane subject-matter that I do not think I ought to go wrong, although I may not apply them properly. I have already said that I put the duty of Messrs. Ball in both cases on the same standard. I do not agree that their duty as auditors would be less than their duty as advising a purchaser who was buying a business. Under those circumstances let us just consider what the case was. The balance sheet of 1903 may be spoken of as what may be called an

ordinary balance sheet; in this sense, that it had upon it the usual items—that is to say, the outstanding credits and the outstanding liabilities. Taking Davies and Tait's balance sheet for the moment, he owed Mr. Mead £1,770, he had a loan from the bank of £631, and he had creditors £2,601. On the other side he had got his fixtures and furniture and his stock-in-trade. The actual amount dealt with in the year was £9,960. When you come to the first balance sheet with which Mr. Ball had anything to do, that of 1903, there are, practically speaking, four items to be considered. The first is on the credit side, stock £6,826; then the fixtures, fittings and furniture £4,620—which make a total of just over £11,500. On the other side there are creditors £4,831, and loan accounts £1,815, making together, as is stated on the balance sheet, £7,647. Therefore, there was for the purpose of the business into which Mr. Mead was supposed to be going to enter as a purchaser—when I say as a purchaser I only mean that he was going to find the working capital and become the owner of a half-share—a balance of £4,800. Goodwill is taken at the low figure in the agreement of £1,000. In some other cases which we are sometimes engaged in, if we were dealing with seven retail shops with this turnover, probably we would have heard a great deal more of the value of goodwill. But it is not unimportant, with reference to what Mr. Mead is supposed to be getting for £3,000, that upon the balance sheet there is not a penny put down for goodwill. It is outside altogether stock, furniture and fixtures. We do not know exactly how it was that £6,000 was agreed upon—£3,000 cash and £3,000 shares to vendor. All I say is that upon the figures it is by no means an excessive amount. It may be said to be £2,000 or £3,000 less than might well have been given having regard to all we know now of the goodwill of the business and the way it was being carried on. They have not so much as had the sum of £6,000. I think Mr. Steele put it quite rightly that there never was £6,000; £3,000 was going to be found for working capital in respect of which a half interest in the business was to be given.

Under those circumstances what is the duty of the accountant employed to protect Mr. Mead? It is to be observed that the only practical assets for the purpose of this case are the stock and the furniture. There were no outstanding trade debtors to speak of, only £49 or a very similar sum. Therefore, what we have to consider is, what is the duty of an accountant so employed to make out a proper trading account to advise his principal in such a transaction? Well, I do attach any importance to the low scale of remuneration. No words have been addressed to me by Sir Edward Clarke, or anybody else in that respect. Messrs. Ball should have charged whatever may be a proper amount, and having regard to what they have done I should assume they were quite sufficiently paid. Only, with regard to certain matters, the clerks do consult their principals and the principals rightly tell them that the work cannot be done. Now, no attack is made upon the fixtures, fittings and furniture, £4,620, in the balance sheet of 1903. Two-fifths of the assets, it is not suggested, have been inflated; to be otherwise than accurate. They are not in any way attacked. There would be a certain amount of investigation required with regard to such an item as that. It is not suggested that Ball & Co. did not properly examine the fixtures and fittings account. The other item is for stock.

That brings us at once to the important and difficult question in this case: What is the duty of a manager with regard to such a stock as this? The business is peculiar, it is carried on in one wholesale and nine retail places. It will probably not be thought that I am going beyond anything proved in evidence in this case when I say that it is common knowledge that chemists' shops do require an enormous number of items. It was admitted by Mr. Fabian that the fittings and property of a chemist's shop, the utensils and so on, are of an exceptionally minute and valuable character. Therefore, there must be very considerable details. This is not unimportant with reference to what I have got to show afterwards. I have gone through the sheets sufficiently to be able to vouch my own accuracy. Each of these pages represents 50 items, either in the whole page or in the half-page. Sometimes the page represents 100 items, sometimes 50, according as they are carried right across or not. Some of the stock sheets are made up one way, some the other. There were, roughly speaking, at Newman Street upwards of 2,000 items. There were at the branches never less than 1,000 and sometimes considerably more, and there were, as I have said, nine branches. Therefore the

items are extremely numerous. Before I deal with the facts of this case, what standard ought I to lay down as to what the duty of an accountant is with regard to the stock? It has been held over and over again, and it has been recognised in the Court of Appeal, that it is not his duty to take the stock. In justice to Sir Edward Clarke and Mr. Gregory, I must say that they do not suggest it was his duty to take the stock. They endeavour to base their argument on a different state of things; they say, given the stock sheets, they were such that no reasonable and prudent accountant would pass them without calling attention to what are now called suspicious circumstances. I do not want to read it at length as part of my judgment, but I will call attention to Lord Justice Lindley's judgment (2 Ch., 1896) at page 284, that in any particular case what is a reasonable amount of care and skill depends on the circumstances of the case, and if there is nothing which ought to excite suspicion less care might properly be considered reasonable than could be so considered if suspicion was or ought to have been aroused. At page 285 he refers to the stock-in-trade being stated 'as per manager's certificate. There were also in the balance sheet entries on the opposite side of the values of the stock-in-trade.' Each year 'the auditors took the entry of the stock-in-trade at the beginning of the year from the last preceding balance sheet, and they took the values at the end of the year from the stock journal'—the book which contained a series of accounts under various heads—and he again refers to summaries signed by manager's certificate. 'I confess I cannot see that their omission to check his returns was a breach of their duty to the company. It is no part of an auditor's duty to take stock. . . . In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to estimate the stock-in-trade.' In this case the auditors relied on the manager. He was a man of high character, competent, and trusted by everyone. The Lord Justice held that the directors were not to be blamed for trusting him. The auditors trusted him in that matter. 'But', it is said, 'they ought not to have done so for certain reasons.' At p. 287 the lord justice proceeded 'Although it is, no doubt, true that such a process might have been gone through, and that, if gone through, the fraud would have been discovered, can it be truly said that the auditors were wanting in reasonable care in thinking it not necessary to test the managing director's returns? I cannot bring myself to think they were, nor do I think any jury of business men would take a different view.

'It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to anyone before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns of a competent and trusted expert relating to matters on which information from such a person was essential.' This judgment is the more important for this reason, that Mr. Justice Vaughan Williams, accepting this principle, had added to it this corollary—which I do not think was wrong in law, though the Court of Appeal did not approve it in fact—that if the figures which he was auditing would themselves enable him to check the stock sheets, that there might be the duty upon the auditors to act upon the result of those figures, and so to have discovered the mistake. That is the passage which is found on p. 350 of 1 Ch., the same case in which Mr. Justice Vaughan Williams had cast the auditors on that ground.* I had looked at that very carefully before I considered the whole of this case, for this reason, it is not suggested by either Sir Edward Clarke or Mr. Gregory that any figures within the stock sheets would have enabled them to discover this improper conduct if it existed. Therefore we have a case before us where, if it is negligence at all, it is negligence with regard to stock sheets and nothing else. That is not an unfair statement of Mr. Gregory or Sir Edward Clarke's argument; I will only say that I wish to call attention to Mr. Justice Lopes' judgment, page 288, from which I commend the words of Sir Edward Carson that he is not bound to be a detective. He is a watch-dog rather than a bloodhound. **Figures of speech are rather dangerous; all I venture to say is, that he has got to act as a reasonable**

* This passage occurs in the judgment of Vaughan Williams, J., in the Chancery Division, i.e. before the *Kingston Cotton Mill* case went to the Court of Appeal. See *The Accountant Law Reports*, 1895, page 230.—Ed.

man under the circumstances of the case. He may even be a detective in some cases if there is something to arouse the suspicion of a reasonable man. I will read the passage at the bottom of page 288 and the top of page 289, also Lord Justice Lopes' judgment about not guaranteeing fraud, and Lord Justice Kaye, page 292, which was read by Sir Edward Carson, or part of it, to-day. I call attention to these passages. I understand them to lay down this rule that the auditor is not bound to take stock; that the highest which can be put against an auditor or accountant in the one case or the other is that he is bound to make a reasonable and proper investigation of the accounts and of the stock sheets so far as he can, and if a reasonable and prudent man would have come to the conclusion that there was something wrong, that then it is his duty to call the attention of his employers to it, and in that consideration he is entitled to take into account the fact that the documents are vouched by trusted servants of his employers. For this purpose I do not draw the distinction which is drawn by Sir Edward Clarke of Mr. Reece not being the employee of Mr. Mead in the first case. In one sense it is true, I have not overlooked that; but he is entitled to rely on the honest servants—those believed to be honest—and experienced in the business of the company whose accounts he is examining. He is not supposed to be put upon inquiry because a later examination shows that something has gone wrong.

I have put together with some care what was done in this case, and I propose very briefly if I can to summarise it in order that my judgment may be self-contained and may show any other judges who consider it the ground on which I proceeded. I do not quite come to the conclusion—I say nothing with regard to any other case—but I do not quite come to the conclusion that in this particular case the auditors were content to take only the certificate of the managers. They are entitled to rely on the certificate of the managers most unquestionably for the reason already given; but I find that the auditors and accountants did in both these cases do more than that. It was their duty to a certain extent to examine the accuracy of the certificates. A part of their duty in that respect is not only found to have been efficiently performed, but is not attacked by the plaintiffs in any respect. In justice to Mr. Fabian, Mr. Dicksee and Mr. Cæsar, who certainly went rather far in some of the things they said, they did not attack the conduct of the defendants in this respect. They said: 'We agree, *prima facie*, given certified stock sheets, all the auditors need do in the first instance, apart from suspicion being aroused, is to take totals and extensions. That would be an ample discharge of their duty when there is a duly certified stock sheet, correcting extensions and totals, and checking a sufficient number of stock sheets which are found to be accurate.' No attack of any kind is made upon the defendants in that respect. It is not suggested that, properly cast or properly extended, these stock sheets have shown a farthing less—still less a substantial sum less. All I can say is that the defendants were certainly undertaking to give to these stock sheets at least that amount of examination. That will appear from the letters of the 2nd September. I am dealing first with the year 1904. That will appear also from the documents read to-day of the 21st April, 1903, of the 16th May, and of the final report of the 28th September. All those documents show, as I have said, that they had checked a great many of the additions and extensions in order to test the accuracy of the sheets, and had in certain cases compared the prices at which the stock had been valued with those of suppliers' invoices. That was the statement of how they discharged their contract in 1903, and if the letter of the 2nd September, 1904, be looked at: 'I got all the stock sheets from Newman Street this morning, and checked the totals on to the summary of totals at each branch. Do you want all the additions checked? It would be rather a big job.' Mr. Cornish replies that he is to check them all. On the 3rd September, 11th September and 26th October that year, it will be found that the defendants were examining the stock sheets from the point of view which it is suggested by witnesses on both sides would ordinarily be sufficient. In the year 1905 the letters of 23rd and 27th October show the same thing. I have not got note of the corresponding letter, but those letters to which I refer are a few of those which I put together to show that in this case it must be taken in considering the duty of the defendants that they had got these stock sheets before

them. I further rule, as a guidance to myself, that, with some slight exceptions where judgment and discretion come in, the skill of the clerk must be the same as the skill of the principal. The principal must not excuse himself for his clerk's negligence by saying that he employed a clerk, and Sir Edward Carson did not contend to the contrary. Of course, it must not be understood that I am dealing with a case where judgment has to be given as to whether a thing has to be treated as capital or revenue. I am not dealing with questions of judgment, but with questions of fact. If the examination of Mr. Cornish would have led him to suspect that there was ground for suspicion, the examination of Mr. Temple ought to have been at least as effective.

I now come to the stock sheets themselves, and here I must, as it were, of course, deal slightly at first with the stock sheets of 1903. Now, it is in evidence before me—I think it is right: I have no doubt it is true—that the stock sheets of 1902 never were before these defendants at all. I can see no reason why they should be, apart from what I will call attention to in a moment about the labels. But I will take it from evidence before me; I am not deciding this case by believing one set of witnesses more than the other. I am not deciding that I disbelieve the evidence of Mr. Fabian or other gentlemen on questions of fact. I do not accept their opinion, as I will show in a moment; but it must not be thought that I have decided this case in favour of the defendants, in reference to part of the case, by disbelieving anything Mr. Fabian or the other gentlemen have said in fact. But, for reasons I will give in a moment, I should not draw the same conclusion as they have done. Subject to their being slightly partisan in one or two respects, both sets of witnesses gave their evidence very fairly. I now come to 1903, and here I am at once pulled up by a most astonishing state of things in this case. It is said that upon the 3rd August, 1903, the estimate of stock, £6,820, was excessive. There are nine shops, nine managers, and there are the Newman Street people. Whether there are anybody besides Kingston and Reece, I do not know; there must have been some others, but they may not have been responsible. It is to my mind very greatly astonishing that in this case the plaintiffs have not made the slightest effort to say that, in fact, not a single item of the stock was not in the shops at the time. If the witnesses were honest, as I should assume them to be, they must have said one of two things: 'I certified that sheet after those insertions, to which attention was called, were made. They were made by So-and-so, and I certified them and they are correct.' Or they must have said: 'I certified those sheets when certain items were left out, and they have been tampered with afterwards.' If the latter were the true state of things, there is no conceivable reason why they should not have been called, or some of them. And the astonishing thing is that, both from the point of view of damages and from the point of view of imputing negligence, from beginning to end of this long case, nobody on behalf of the plaintiff had suggested what the effect of these additions would be either in total money or the items to which attention has been called.

Let me take a striking instance, though it is not in this particular year. We have not got Newman Street here. There are in every case three or four entries in the bottom of a page of considerable amounts, in a handwriting different to the bulk of the page. I have tried to make out in my mind what is the theory which suggests that the attention of the auditors should have been called to this fact. Were the lines supposed to be blank? If so, why should they be left blank? If not blank, but filled up in a strange handwriting, why is no explanation given? It has made a very deep impression on my mind that not one single one of the managers of these nine shops has been called. It is only three or four years ago. I can see no reason why honest people should not have been called to say either, 'These stock sheets are in the condition I certified', or 'They have been tampered with since'. On the face of these stock sheets themselves—I am speaking entirely of 1903—I will endeavour to summarise for the purpose of my own judgment what I find about them. I find several different handwritings sometimes, certainly two or three. I agree with Mr. Dicksee that frequently the figuring seems to be done in a different handwriting from what I may call the writing out of the articles. That is what you would expect. I find corrections both ways. It is quite true that the particular items to which attention has been called do, in fact, make additions in considerable amounts; but I find corrections both ways. I find

the corrections in a different handwriting, and I find writing which, even if the same—though I am not sure of that—has obviously been made at a different time. To many of these things no attention has been called at all. I know the witnesses for the plaintiff have said that there are a great many other things of the same character to which they could call attention if they liked, but I ask myself, looking at these stock sheets, what is there to arouse suspicion? Now, in fairness to Mr. Dicksee, he said to me, when I took him through one, 'That stock sheet would not have been enough of itself. But,' he said, 'it is the cumulative effect of all the stock sheets in that year 1903 which would have aroused my suspicions.' I have a little difficulty in judging that. It is quite clear that you are not to assume that the work must always be done by the same clerk. But taking it that Mr. Temple saw them all, you have got to come to the conclusion that, with these tens of thousands of entries, he is to carry minute entries from one page to the other so as to arouse his suspicion. And that, in the face of a certificate of a man believed to be honest, who has certified that the stock is there.

Now I come to the case which has been made in addition to that upon this part of the matter—that is, the labels. For some reason or other which I cannot explain, the case has been left absolutely bald of any evidence at all. I have not even been told what would be the average amount of labels for a retail chemist's shop. I have no idea. All I have got is what I can gather from this case, that is, that the warehouse labels were put down at £475. At the nine shops they are put down as £210. If you divide £210 by nine, it makes an average of £25. If you divide £475 by nine—for the warehouse is only averaging the other shops—it makes it as nearly as possible £50 for each shop. I have not the slightest idea, nor can I form any conclusion, as to whether or not, if you have got £475 of labels—between £45 and £50 for each shop—in the whole concern, particularly in respect of the proprietary medicines, whether £25 a shop is too much for the shops. The plaintiff knows perfectly what he ought to prove—for aught I know he has tried to get evidence and cannot though I do not speak of that—and I want to know what right he has got to ask me to come to the conclusion that it ought to be suspicious because I find £25 worth of labels is put down for a particular shop. Then it is said that because he was told—I quote now from memory—that the £475 had been increased because the labels had been brought from the shops to the store, and all the proprietary articles labelled in the store, not the shop, it is said that ought to put him on inquiry as to why there were still any labels at the shops at all. If the state of things is to be such that an ordinary accountant ought to draw that conclusion, at least the Court is entitled to ask for some evidence of it. As I have said, I do not know—except from the visits which I sometimes have to pay to chemists' shops—I do not know the number of labels that would be required. I do not think they can possibly be small; Mr. Gregory would not assist me by recollections of an early novel which I hoped he had read, and all I say is that I have no means whatever of judging as to whether or not there is here sufficient evidence of negligence. Looking at it for myself—as I do not know, or it is not suggested to me, what the total effect is, as I have no evidence to show that these shops ought to have so many labels—I cannot come to the conclusion that any reasonable man, looking at those stock sheets, would have thought there was something suspicious so as to call the principals' attention to it in the year 1903.

With regard to the year 1903, the other matter relied upon is based solely upon a statement made by Mr. Ball in the minute of 1907, that four items had been held back and not included in the list of liabilities taken over by the accountant. As I have said, I use that—and the plaintiffs are entitled to use it, so far as they can—against Mr. Ball. At the same time, what does it amount to? It is a statement that somebody, for some reason or other, has kept back four items from the 1903 balance sheet, and that these have not appeared until 1904. In this part of the case I must deal only with the 1903 balance sheet. I find, as a fact—and the evidence is all one way—that it has not been proved to me that there is a single entry in the books of the company which did come before the accountant, or in any document which must have come before the accountant, that these items ought to have been included. I find, as a fact, and, so far as they touch the point, I believe the statements made by the defendants' witnesses, that they did not see it. For this reason, that they have honestly ticked every entry they

saw. It was opened by Sir Edward Clarke that they ticked these incriminating entries, and ought to have seen the mistakes, as they had the entries under their eye. That has been disproved: Mr. Ball, Mr. Temple and all those who represented the defendants swear that the green ticks are not their ticks; and that statement has not been cross-examined to by the plaintiffs. Therefore I come to the conclusion that, when auditing the books in 1903 the defendants had no document before them which would have shown the omission of those four items. With regard to three of them, I will not stop to point out in more than one sentence the distinction which I think arises between them. With regard to the first three items—Haycroft, Haskins and Shoolbred—I can see a reason why they might properly be even excluded, because they related to the fittings of the Kentish Town shop, and were part of a much larger item; but I say again, I do not rely upon that, because Mr. Ball has taken the view they ought to be put in. With regard to the £69 3s., it depends upon there having been some voucher or statement which Messrs. Ball's representatives ought to have included and which they overlooked. Witnesses for the plaintiffs, who had these books under their careful consideration, are not able to show any single item which ought to have called their attention to that. Under these circumstances, I come to the conclusion that this omission to include in the 1903 balance sheet the items which afterwards appeared in the 1904 balance sheet fails; and upon the allegation made with regard to the claim made by Mr. Mead, I find that there was no negligence on the part of Messrs. Ball, and that, in discharging their duty as they did discharge it, rendering accounts and reports to Mr. Mead in the year 1903, they discharged their duty in accordance with their contract, and are not liable to damages in the action.

The case of the company rests upon a rather different state of things, but it does not involve any different considerations of law, and I do not rebate what I have said about the duty. They audited in 1904, 1905 and in 1906, and the suggestion made is that in 1904 the defendants were negligent in respect of the stocks and negligent in not discovering the previous omissions of 1903. What it would have mattered if they had then discovered it I have never been able to see; but I will assume for this purpose that it might have had some influence upon somebody's mind if they had found out that these things ought to have been properly attributed to the earlier three months—these four items, I mean. But the main complaint is the same, that the stock had increased to £8,700, and that the stock sheets themselves—it being the main asset apart from the fixtures and furniture—should have shown the defendants that there was something wrong.

I may as well now deal with these three years, and also with the first, in one sentence as regards one part of the case, because a certain reliance has been placed upon it by Sir Edward Carson, and, I think, rightly placed. In each one of these years—certainly in three, if not in four—the auditors pointedly called the attention of the directors to the increase in stock as appearing on the balance sheet; and they gave the explanation given them which could only have come from Mr. Reece. That it was so given is confirmed by Mr. Mead, who says that he asked Reece the question, but got the same answers. Reece told him that it was necessary to have more goods in order to do a larger trade, and in the earlier years I think he also mentioned that they were opening further shops. Therefore, so far as attracting the attention of the directors to the fact is concerned, the auditors undoubtedly did it. But what passed through my mind, and what affects my mind is this, if it did not arouse, or ought not to have aroused, the suspicions of Reece and Mead, why should it have aroused the suspicion of the auditors? At this time, as I wish to point out, you are entitled to distinguish Reece from Mead for the purpose of duty to the company. Reece was just as much a shareholder as Mead for this purpose, and **why should it be supposed that it is to arouse the suspicions of the auditors when the fact of the increase of stock and the existence of increased stock is called to the attention of the directors by the auditors and no comment of any sort or kind is made?** The reason given may be a very bad one, but it is believed. As I have already said, I am not called upon to make up my mind at what epoch in the story Mr. Reece became fraudulent—if he did become fraudulent—or how it was Kingston says that at the same time they took to inflating the stocks.

All I say is I have yet to learn that if the auditors call the attention of the directors of the company to the fact, they may not also rely upon the fact that the directors of the company, with that information before them, make no further comment and give no further instructions. Mr. Mead told us that Reece told him it was necessary to have the stock. That something of the kind was said appears from some of the reasons given in the reports made by the defendants. They pointed out that the increase of stock was more than the total gross profit; so they were investing all their profit, and they give another illustration of the extent to which the stock had been increased. But apart from the year 1904, I must say I certainly should have thought that the fact that the attention was being called of Mr. Mead, who was a director, and of Mr. Reece, who was also a director, to this fact, and that neither Mr. Mead nor Mr. Reece—certainly not Mr. Mead—thought it their duty, or fair to the auditors, to give them any extra caution, is a circumstance not to be lost sight of when we are dealing with alleged negligence in three consecutive years; and I find as a fact, and do it on the evidence of Mr. Mead himself, that up to September, 1907, Mr. Mead had no suspicion of Mr. Reece at all. He said that he had asked him several questions and was always getting certain answers. In the light of what we know now, those answers might not have been satisfactory; but that Mr. Mead did not suspect Reece is clear, because it is common ground that in September, or thereabouts in 1907, he asked Mr. Cornish if he had any suspicion against Kingston; Mr. Reece's resignation was not brought about until the day after the rupture, so to speak, had taken place, when Kingston was suspended.

Under these circumstances I have to answer myself the question. Are the stock sheets examined as they were in 1904—and in all the years, I make no distinction—are the 1904 stock sheets such as would arouse the suspicion of a reasonable man? Here we have got the Newman Street document, and we have got the certificate of Mr. Reece and Mr. Kingston, and the certificates of the nine branch managers. I have done my best, not by a hurried examination, but by a most careful examination; I have looked at those stock sheets with the greatest care, and I have turned them over as I think one would turn them over—not looking at items which are marked until one has made his mind up as to the general aspect—and I find four items pointed out as suspicious at the bottom of one of the sheets, and an item of three lines one-third of the way up. I ask myself when could these have been written. In between the attacked items there are several very peculiar items which are not attacked at all. To give an illustration, one attacked item is three dozen antexema, another is 24 dozen Scott's emulsion, 15 dozen Scott's emulsion, and 36 dozen assorted wines. I ask myself what happened here? Am I to assume that these lines were left blank, and then filled up afterwards? If so, a witness ought to have come and told me so. Or am I to assume that they were written in at the time? If they were written in at the time, there is no inference to draw hostile to the sheets, however many different people are doing them. One man has got as far as certain items; then he comes across a batch of Scott's emulsion or wine and puts it in. I am not ordinarily of a suspicious temperament, and I have a difficulty, looking at those items, to see why that is sufficient to arouse suspicion. Putting it as fairly as I can to these witnesses, I say that on turning over those sheets you see a number of alterations, but what is to make you think that they have been tampered with by somebody? The plaintiff says it is the number of alterations; I am a jurymen for this purpose, and all I can say is that, looking at the stock sheets I should not have come to the conclusion that they had been tampered with. I am not an accountant, but I must say I do in this respect, for the reason I have given, prefer the evidence of the defendants as compared with that of the plaintiffs. It is extremely easy when you are wise after the event to pick out particular things and say that they would have indicated to you that there was something wrong about the stock sheets—that is the strongest that it has been put to me—calling for further inquiries. All I can say is that it does not to my mind appear to be a reasonable view. I do not understand, if this is so, why there should be a certificate of the shop manager in respect of each case. Either they must all have been fraudulent, or all have been hoodwinked and made to leave those places to be filled up. There is no conceivable reason why that should have been done. You may say to yourself

you have got accountants of respectability who come and say they would have thought it suspicious. One cannot help saying that this is evidence given after a fraud has been discovered—if it be a fraud—and again here I am in a difficult position, as I wish to point out; because I do not know to this moment how much stock is said to have been short in the year 1904, either in amount or in quantity. I have not the least idea what the suggestion of the plaintiffs is. They have taken no pains whatever to put it before me; all they have said is that these entries would have been enough to have aroused suspicion. I have looked at the so-called confession of Mr. Kingston; it does not enable me to come to any other conclusion than that at some time things were inflated, whether that means 1904, 1905 or 1906. There is some indication that it was later than 1904, because he speaks of a time when he had to find his own money to meet pressing wants and payments, and it does not look as if it was very early in the proceedings. However, I can only say I have come to the conclusion that a reasonable man doing his duty might well have been led to the conclusion that there was nothing suspicious about those stock sheets. It must be remembered they are original documents; I think this is a matter of the very gravest importance. Both Sir Edward Clarke and his witnesses agree that if this had been what I may call real fraud the simplest thing would have been to have fair copied the stock sheets. Then nothing would have been discovered. They would have been certified in the same way. Every witness, both for the plaintiff and for the defendant, said that one expects to find corrections in the original stock sheets. When you come, as I think Sir Edward Carson put it, to have a parcel of stuff, some of which may be in the shop, some in the back shop, some upstairs, you may have to add the thing together. I decline to find people guilty of negligence on this kind of inference unless I feel satisfied without reasonable doubt that any prudent man looking at those stock sheets would have come to the conclusion that they were suspicious—I use no stronger word; I cannot think they were suspicious.

Now the omission of the accounts in 1903, with regard to those four items, is relied upon by Sir Edward Clarke as showing negligence in 1904. As to that I must just state one fact in addition. In November, 1903, the business was sold to the company for 3,000 shares fully paid up, the company to undertake to pay all the liabilities of the firm as it stood to the 2nd August. Therefore, if they had really paid the money, it does not matter whether it ought to have been included in the 1903 balance sheet or not. I want to make this point clear in order that I may not be misunderstood. In Mr. Mead's action it might be of some importance, because it would to a certain extent affect the profit and loss in that year; but in the company's action, if they had to pay those bills, it makes no difference from the point of view of damage. What are the facts? The facts are they did pay them in the twelve months ending August, 1904. I think they were passed by the directors and paid by the company's cheques; and in the accounts rendered by these defendants they put the payments in, and, of course, the receipts were in another shape, not as the receipts for sales. But they put the payments in and included them, and but for the fact that Mr. Ball himself found out in the year 1907 that they ought to have been included in the accounts of 1903 this charge of negligence could not have been launched at all. I believe the witnesses for the defence here, who say, 'We were shown the payments had been made in the year and we included them in the year'. As Mr. Cornish said, 'I knew at the time that the company had to pay all the debts, and therefore if it was a bona fide payment made by the directors it was not only no part of my duty, but it would have been outside my province, to say to the directors that they ought not to have paid this sum in 1904.' They ought to have paid it. I believe this charge was only brought in consequence of what Mr. Ball said when he made that report pointing out that there had been, as he thought, a suppression by Kingston or somebody when Mr. Cornish had been asked the question whether Kingston was honest or not. I attach no importance to the fact that Mr. Ball was appointed director. I attach no importance to the fact that Mr. Cornish was appointed secretary, beyond this: that it is not suggested that Mr. Mead had any suspicion of them at that time. Therefore everything which is said against them rests on something which has been discovered after that. If it ought to have been discovered before, it is equally cogent assuming it to amount to a proof of negligence.

I think, with one exception, I have covered the ground which is alleged to establish negligence. I find as a fact that in auditing the accounts of 1904 and 1905 there was no negligence. If 1906 had stood alone, I think that possibly the character of some of the stock sheets only might have led one to the just observation that they were not so satisfactory; but I cannot take that one stock sheet for one place—it is only Newman Street—by itself. It is very carelessly made up. I have gone through it most carefully, and I find mistakes in both directions, apparently made by somebody who wrote very badly. I am unable to say that there is any negligence in the year 1906. It would have had no effect on the substantial case made against these defendants; but I come to the conclusion that in none of these years was there any evidence on which I can find them guilty of negligence.

With regard to the defence raised under the articles, I have some doubt. It is quite true there is a judgment of my brother Neville's to which I should pay the greatest respect, having regard to his experience in company matters, upon the words of this article itself; but that was a case of directors, and there is this further observation that occurs to me about it, that I am rather impressed by the very clear argument of Sir Edward Clarke that it is possible to construe the last part of that Article 149 as not including negligence. I do not give any judgment against the defendants in respect of it; but as it is not necessary to decide it I do not go into the matter further. I am not altogether satisfied that, if negligence had been proved, Article 149 would have been a defence. I should have required further argument before I came to that conclusion.

I am sorry to have occupied so much time; but it is due to the argument addressed to me. I am painfully conscious I have omitted to notice some of the details. I do not think I have omitted to notice any substantial head of the plaintiffs, but I come to the conclusion in both cases that the action fails. Both actions must be dismissed with costs.

CORK MUTUAL BENEFIT TERMINABLE SOCIETY *v.*

ATKINS, CHIRNSIDE & CO.*

(Decided by Mr. Justice WRIGHT, in the Irish Court of King's Bench,
on 31st July, 1911)

On an action against auditors for damages arising out of alleged negligence; held, that failure to examine all the pass books of members is not necessarily evidence of negligence; and that while an erasure might excite attention, where there were no suspicious circumstances, failure to notice one is no ground for making an auditor liable.

This action, which involved an important question as to the liabilities of chartered accountants acting as auditors of companies, was brought to recover the sum of £81 odd alleged to have been lost to the plaintiffs through the negligence of the defendants, a firm of chartered accountants, while acting as the auditors of their accounts.

JUDGMENT

The judge, in delivering judgment, said that this was an action for the sum of £81 odd, which had been tried before himself without a jury at the Cork Assizes on the 26th and 27th July. It was an important action to the plaintiffs and to building societies generally, and it was an exceedingly important one to the defendants, who were a well-known firm of accountants in Cork, the partners in which were Mr. Chirnside and Mr. Olden, because the action was one for negligence of that firm in the discharge of their duty as auditors of the plaintiff society.

The plaintiff building society had been incorporated about the year 1896; it did not appear who had been auditors up to the year 1903, but in or about that year the defendants were appointed to audit the accounts of the society and he took it that they were duly appointed every year till 1908, when the matter occurred which gave rise to the present action. It appeared that the secretary of the society was a Mr. O'Connor, who in reality had the whole management

* *The Accountant* L.R., Vol. XLV, p. 13.

in his hands. In the end of the year 1908 there were some charges against him in reference to irregularities not in any way involving dishonesty, but the society was put upon inquiry, and in September, 1908, when O'Connor either resigned or was dismissed, the auditors were directed to make a special report and to examine all the pass books of the members. A special examination and report was accordingly made by the defendants as auditors, and they reported that there was a deficiency of £131 odd on the cash account—that is to say, it appeared that O'Connor, from the accounts as they appeared in the books, was in default to the extent of £131, which sum was afterwards paid to the society either by O'Connor or on his behalf, whether with the idea that O'Connor might be continued on as secretary or not, he, the judge, did not know. In addition to this £131 the auditors reported that there were differences between the pass books and the books of the society, in one or two instances the ledger showing that there had been paid more than was credited to members in their pass books, but in some cases that the pass books showed that more money had been paid by members than was credited to their accounts in the ledger. A list of the pass books which appeared to differ from the ledger was furnished to the society by the auditors, and in November, 1908, the deficit was ascertained. O'Connor had given a guarantee, the Ocean Accident Corporation being the guaranteeing company, but this guarantee, amongst other limitations, was confined to one year. The total sum involved was about £167. The Ocean Accident admitted £46 and paid £40 in settlement of their liability, making £86 altogether, which being deducted from the £167 left £81, the claim in this action.

The action, as he had said, was one of negligence. The law applicable to the case was in reality not in dispute, but he had thought it better to reserve judgment in order to examine the authorities. He would only refer to three which were the ones cited to him at the trial. The first was the case of *Leeds Estate Co.* (36 Ch. D., p. 787) at page 802. Mr. Justice Stirling said as follows: 'The auditor's duty is not to confine himself to merely verifying the arithmetical accuracy of the balance sheet, but to inquire into its substantial accuracy and to ascertain whether it is properly drawn up so as to contain a true and correct representation of the state of the company's affairs'. The next case was the *London and General Bank* ([1895] 2 Ch. 683) where Lindley, L. J., says: 'It is the duty of the auditor to examine the books not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position, and this is quite in accordance with the decision of Stirling, J., in the *Leeds Estate Co.* An auditor is not bound to do more than exercise reasonable care and skill in making his inquiries. He is not an insurer, he does not guarantee that the books are correct or show the true position of the company, he does not even guarantee that his balance sheet is accurate according to the books of the company. If he did he would be responsible for error on his part, even if he were himself deceived, say, by the fraudulent concealment of a book from him. He must be honest, he must not certify what he does not believe to be true, and he must take reasonable care. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient, and I believe business men select a few cases haphazard, see they are right, and assume that others like them are correct also.' The last case to be mentioned was *Re Kingston Cotton Mill Co.* ([1896] 2 Ch. 279) in which Lindley, L. J., at page 284, says: 'An auditor is not an insurer, and in the discharge of his duty is only bound to exercise a reasonable amount of care and skill.' And Lopes, L. J., at page 288, says: 'An auditor is not bound to be a detective, or to approach his work with suspicion or with a foregone conclusion that something is wrong; he is a watch-dog, but not a bloodhound; he is justified in believing the tried servants of the company, he is entitled to believe they are honest and to rely on their representations.'

Now in this case the real complaint was that the auditors did not get the pass books of each and every member of the company, and the plaintiffs say that if this had been done a great part, at all events, of the discrepancies would have been discovered earlier. The rules of the society make no express reference to the production of the pass books, and no duty as to their production is expressly thrown on the auditor; but this leaves open the question as to whether non-insistence upon the production of each and every pass book was negligence on

the part of the auditors. The first witness for the plaintiffs, a Mr. Curtin, the present secretary of the society, seemed to be of the opinion that the auditors ought to have got in all the pass books. He admitted, however, that there was great difficulty in so doing and that a number had never been produced. Mr. Stapleton, an accountant, was the second witness for the plaintiffs; his advice was of importance, because he was the auditor of another building society in Cork, the Munster Building Society, the rules of which were produced, and included a rule specifically requiring every member to send in his pass book before the audit. Mr. Stapleton, in cross-examination, admitted that notwithstanding this rule there had for a long time been great difficulty in getting in the pass books, and that he believed that sending out notices to members informing them of how their account stood in the books of the society would be an efficient check. Now the particular items complained of divided themselves into three heads, first, seven or eight small items, being monthly subscriptions which were undoubtedly paid and appeared in the pass books, but were not credited in the ledger. As to these, he came to the conclusion that with the exception of one, No. 698, O'Sullivan, none of these books had ever been produced to the auditor. Then there was one case in reference to a larger amount, Mrs. Berkely, who paid £12 3s. 0d., for which she got no credit. There is no evidence whatever that her book was ever before the auditors. **It was not the auditors' duty to get in the pass books; they had to depend upon the secretary to produce them, and they examined every pass book that was produced.**

Then there were two cases, that of Mr. Woulfe and Mr. Cross, where they paid by cheques. In Cross's case Mr. Cross admitted that he could not say whether his pass book had ever been with the society since 1904, and Mr. Woulfe said that he believed he gave his books to the secretary in 1905 and never got them back, and in his case the misfeasance relied on was in 1906, and it was clear that neither the books of Mr. Woulfe or Mr. Cross were before the auditor at all. There was only one other case which had to be mentioned, because it was of a different class: a Mrs. Kirkby paid in £22 19s., and only £2 19s. was credited in the ledger, the first '2' of the '22' having been erased. **It was said that the auditor ought to have seen the erasure. The erasure might have excited attention, but at the time O'Connor was under no suspicion, and it is quite impossible to hold the auditors liable. Mr. Brew, who did the actual work, says that he did not notice the erasure, and that the account was totted with the figure standing at £2 19s.**

As regards the witnesses for the defendants, Mr. Peterson and Mr. McGovern, both chartered accountants, were examined, and in their opinion it was in no way the duty of the auditors to examine every pass book, and that sending out the notices informing members of the amounts standing to their credit was a much more efficient check. Lastly, Sir Robert Gardner, whom everyone knew as the most eminent accountant in Dublin, stated emphatically that the defendants had really done more than their strict duty, that the examination of pass books was no real check unless all could be got in, which was in fact impossible. What he, the judge, had to decide was whether the defendants had acted with reasonable care and skill. He said that he had come to the conclusion on all the facts and circumstances of the case that the auditors had discharged the onus that rested upon them, and that they had done all that they could be reasonably expected to do, and accordingly, after full consideration of all the facts of the case, he gave judgment for the defendants with costs.

MEAD v. BALL, BAKER & CO.*

(Decided by COZENS-HARDY, M.R., and FLETCHER MOULTON and FARWELL, L.JJ., in the Court of Appeal on 21st November, 1911)

Appeal from the decision of the Lord Chief Justice; held, that in the circumstances there was no evidence that plaintiff advanced money on the strength of defendants' report, and that therefore he had no cause of action, apart from the merits of the case, which were rightly decided in the Court below.

This was an appeal by the plaintiff from a decision of the Lord Chief Justice.

* *The Accountant* L.R. [1911] 33.

The action was brought to recover damages from the defendants for the negligent performance of their duties as accountants.

For about ten years before 1903 a Mr. Reece had carried on business as a cash chemist at various shops in London in the name of Henry Squire. Owing to the opening of new branches Reece required financial assistance, and at the end of 1902 he had raised £1,200 on mortgage from the plaintiff. Early in 1903 he wished to obtain more money, but the plaintiff was getting uneasy and was thinking of calling in his mortgage. It was suggested that the business should be turned into a limited company, and the plaintiff insisted that an independent firm of accountants should be employed to ascertain its value, as he was not satisfied with a report prepared by Reece's own accountants. The defendants agreed to make a report, and did so in August, 1903. On that report the plaintiff went on to form the company and invested upwards of £3,000 therein.

The plaintiff was substantially the only person who put money into the company, and he and Reece were its only directors. The defendants were appointed auditors of the company. The company continued to carry on business until 1907, and the auditors prepared yearly balance sheets during that time, but failed to discover falsification of documents, non-disclosure of liabilities, and other acts of fraud which had been going on since 1903. Finally, in August, 1907, the defendants discovered the frauds, and in 1908 the company's business was realised, with the result that the debenture-holders received 9s. 6d. in the £, while the creditors and shareholders received nothing.

The failure of the auditors to discover the frauds subsequent to 1903 was the subject-matter of an action entitled *Henry Squire (Cash Chemist) Ltd. v. Ball, Baker & Co.*, which came before the Lord Chief Justice at the same time as the present action. There was no appeal from the judgment of the Lord Chief Justice in that action, dismissing the plaintiff's claim.

The present appeal related only to the report made by the defendants in 1903, on the strength of which the plaintiff had invested £3,000 in the company when formed.

The Lord Chief Justice, in giving judgment in the Court below, said that the charge of negligence was based on the state of the stock sheets. It was not the duty of an auditor to take stock, but the plaintiff alleged that the stock sheets showed suspicious circumstances. It had been said that an auditor was not a detective, it was his duty to exercise what was reasonable care in the circumstances. The most that could be said was that he must make a reasonable and proper investigation of accounts and stock sheets, and if a reasonably prudent man would have concluded on that investigation that there was something wrong, it was his duty to call his employer's attention to the fact. In making his investigation he would be entitled to rely on documents vouched by servants of the business at whose accounts he was looking, unless there was some reason for believing those servants to be dishonest.

As a matter of fact the defendants in this case had not been content to rely on such documents, though they would have been entitled to do so. His lordship went through the stock sheets in detail, and in conclusion said that in his view it could not be said that a reasonable man must have found something suspicious in them, and that, therefore, there must be judgment for the defendants.

From this decision the plaintiff appealed.

Sir Edward Clarke, K.C., in opening the appeal, said that two actions had been brought against the defendants for negligent performance of their duties as accountants. The first had been brought by Henry Squire (Cash Chemists) Ltd. and the second by the present appellant. The two actions were closely connected and had been heard together by the Lord Chief Justice, who had dismissed both actions. There was no appeal in the company's action, and his submission in the present appeal was that the Lord Chief Justice had decided Mr. Mead's by applying the same principles that he had done in the company's case.

In the case of the company, accountants acting as auditors might be justified in relying on the reports of trusted officers. There was, however, no such justification for accountants when they were advising an individual who proposed to purchase the business carried on either by an individual or a company. In such a case the purchaser was at arm's length from the vendor and was not trusting in either the vendor or the agents of the vendor.

Counsel then went through a number of items in the stock sheets and other matters, from which he submitted that if the defendants had exercised reasonable care they must have discovered that frauds were being perpetrated. The decision in *Re Kingston Cotton Mill Co.* (No. 2 [1896] 2 Ch. 279) was not applicable to the facts of the present case, and as there was evidence that the plaintiff had suffered damage through the failure of the defendants to discover these frauds, he was entitled to recover damages.

At the conclusion of the argument on behalf of the appellant their lordships dismissed the appeal without calling upon the respondents.

JUDGMENT

COZENS-HARDY, M.R.: This is an appeal by the plaintiff against a judgment of the Lord Chief Justice, who tried a very serious and important question, in which Mr. Mead sought to recover damages against the defendants, who are auditors, for negligence resulting in damage to the plaintiff. Although I am bound to say that I think this appeal fails, and that the form of the judgment of the Lord Chief Justice was quite right, I desire, not having heard Mr. Sankey's observations as to the precise limit and extent of the duties of an auditor towards his client in a case like this, to say that I keep an open eye as to whether those duties are or are not as certain and defined as they purport to be defined by the Lord Chief Justice. I only state that because I wish in my judgment to say that I entirely agree, as at present advised, with the limitations which the Lord Chief Justice put upon the duties of an auditor.

Now the case, I think, may be narrowed to a very short point. Mr. Mead had had business relations with Mr. Reece, who was carrying on the business of cash chemists, a business carried on in Newman Street, with eight or nine branch shops. He did not suspect Mr. Reece, so far as appears, and he did not in the least imagine that he was guilty of fraud. Mr. Reece, who had had an advance of, first, £1,200, and then of £507, from Mr. Mead, was desirous of obtaining a further advance. He applied through, I gather, Mr. Steele (who was the solicitor both of Reece and Mead) to Mr. Mead for help, and Mr. Mead very prudently said: 'I must have this matter looked into by an independent auditor; I want to see how matters are going on, and whether the business is properly conducted.' Mr. Steele, acting for Mr. Mead, made an offer to the defendants, Messrs. Ball, would they undertake this duty at an agreed fee? The fee was agreed. No question arises as to the amount, or anything else, and undoubtedly there was a perfectly good contract for value between the plaintiff and the defendants with reference to the obligations imposed upon the defendants as auditors in a transaction of this kind. They were furnished, amongst other things, with the account of the previous year made by auditors employed by Mr. Reece. They also were furnished with stock sheets, all but one of which we have seen here, the one from Newman Street being missing, and they purported to be stock books for each of the branch establishments, showing in great detail items extending over hundreds, and, I might say, thousands—so many pills brought out at so much, and so many boxes at so much, and so many labels at so much, and in addition there were entries of a lump kind, occurring mostly, if not in all instances, either at the top or the bottom of the stock sheets, and those items were brought to a very large extent to lump sums, such as 'labels', the lowest value. In one case it is 'Labels, lowest value about £15 or £20', or sometimes it is £10. The stock sheets are not altogether in one handwriting, and I assume now favourably to the plaintiff—not having heard Mr. Sankey—not deciding, but assuming for the purpose of argument that there was so much in those stock sheets which were under their eyes, or under the eyes of their clerk, for whose negligence they are responsible—I assume, without deciding, that it was negligence on their part not to have asked for an explanation of them. Although it is quite clear that it is not the duty of an auditor to take stock, one cannot say that it may not be his duty to call attention to suspicious items appearing in stock sheets which are put before him.

But assuming all that, assuming that the negligence has been proved, what further has to be established? It surely has to be established that it was the negligence of these defendants which induced the plaintiff to lend his money, as he subsequently did, or to take shares in the com-

pany, as he subsequently did, on the strength of this report. Well, in the first place, he goes into the box, and he does not say so. In the next place, is it a legitimate, I might almost say is it a necessary, inference that if they had done their duty and there had not been negligence the advance would not have been made? I am wholly unable to draw that inference. Again, not having heard the other side, but taking the case which has been opened to us, there is the item of the labels, which I am bound to say strikes me more than anything else, and what does that amount to? It amounts to this, that there was an over-statement of the value of the stock to an amount of 3 per cent., and perhaps more or less, I care not which, but to the amount of 3 per cent. only, the stock being, according to the defendants, a little over £6,000, the label items being £200. Is it at all a legitimate inference to say that an over-statement of stock to the amount of 3 per cent. was such as would have induced Mr. Mead to make this advance? I entirely decline to draw any such inference. It seems to me that the whole thing, so far as appears, does not necessarily involve fraud on the part of the persons who did it. The mere discovery by the auditors of these inaccuracies, which for the present purpose I assume they ought to have discovered, is something very different indeed from a discovery of the scheme of fraud which is suggested on behalf of the plaintiff. I say 'suggested', because there is not a particle of evidence—I use that word advisedly—of fraud in these 1903 accounts. The only suggestion is that in another action brought by a company against the same gentlemen as auditors, the statement was made to Mr. Mead, and was, in fact, adopted by the company and treated in that action by all parties as true, that the man Kingston, four or five years after—I think in 1907—confessed that he had inflated the accounts habitually and regularly, at any rate for a year or some years before, and certainly for years after 1903. A confession of that kind made by Kingston, not in any way a party to this action, cannot possibly be regarded as evidence of any fraud proved in 1903.

It remains thus—assuming negligence, assuming that the accounts were inaccurate, and would have been established to be inaccurate if the defendants had done their duty in 1903, does it follow that the plaintiff, who does not say that this inaccuracy would have made any difference if he had known of it—does it follow as a necessary consequence that it was this negligence which resulted in the loss which he sustained? It seems to me quite clear, given a mere inaccuracy in a report, even though it be due to negligence in the report, it by no means follows that if that inaccuracy had been corrected it would have led to a different result. Of course, if they had done their duty, and they had been bound to find the fraudulent conduct of Reece or his subordinates, different results would have followed. There is not a tittle of evidence so far as I have heard to show that Reece himself was fraudulent. It may or may not have been so, but there is no proof that Reece himself is fraudulent throughout the whole of the transaction. In my opinion, without going further into the case, we ought to hold that, however negligent they may have been, the plaintiff has not succeeded in proving that which he has pleaded in paragraph 6 of his statement of claim, and on that ground the decision of the Lord Chief Justice was correct, and this appeal must be dismissed with costs.

LORD JUSTICE FLETCHER MOULTON: I am of the same opinion. In this case the plaintiff has to prove negligence on the part of the defendants, and also that the negligence caused him damage. First of all, let us consider what the negligence alleged is. The negligence, put in a concrete form, is that the defendants ought to have discovered that the stock was over-valued; in other words, that fictitious items of stock had gone into the stock sheets and been carried into the totals, and also that certain liabilities which actually existed were suppressed, and that the defendants ought by a proper examination, such as an accountant ought to make, to have discovered those facts.

Now, first of all, let me take the case of the inflation of the stock. It relates partly to the stock of labels and partly to other things, but there is not one particle of evidence that everything which appears in the stock sheets was not actually at the branches or at Newman Street at the time. The view for my part which one is inclined to take, knowing that some years after the confidential servant of the company, who was then the servant of Mr. Reece, and who had been employed during all these years in the business, gave a written confession

that he had during the whole of the time been guilty of fraud in the way of making fictitious entries of stock, and in other ways, colours one's mind at this time, and makes it very necessary that one should guard oneself against accepting things which, if they were true, ought to have been proved by evidence against the defendants in the case. There is no evidence whatever that there was any fraud at the time, and therefore we cannot assume that these items which are objected to in the stock sheets do not represent goods actually in existence. It is perfectly true, if they were commencing an investigation, the fact that they are made in the handwriting which was probably the handwriting of the superior confidential clerk, Mr. Kingston, is a thing which once having started suspicion one would regard as a matter of gravity; but to a person who examines these accounts without the slightest idea that there is any possible fraud, the fact that an item was in the handwriting of Mr. Kingston would probably make him justly pass it with less inquiry than if it had been in the handwriting of a subordinate clerk. So far as the items other than labels, there is no evidence whatever that there was any negligence in connection with them.

Now I take the labels. This is a case in which, I think had suspicion once been aroused, it might very likely have led to a second investigation which would have discovered the fraud if there was any fraud then, but I find that there is nothing in the evidence before the Court which proves that these labels were not there except one thing, and that is that the amount for labels, the value of the stock of labels is, according to the evidence of the experts, very much higher than one would expect in such a business as this. If that was so, it was certainly not a thing that an auditor or an accountant could be expected to know; how much a portion of the stock of a business like this—things that are called cartons and labels—should be I certainly do not know, and I cannot expect that they would know. But if the magnitude of the item is that which should have excited suspicion, the client was certainly told of it, because he was told that included in the stock at the warehouse are labels and cartons to the amount of £475, and there is £335 shown in the balance sheet of the 2nd August, 1902. **If it ought to have alarmed the defendants that the figure was so large, I can conceive no reason why it should not alarm the plaintiff just as much. I cannot impute in law a higher duty of knowledge of details of that kind of a retail chemist's business to one than I can to the other.** But, apart from that, it is said, and I confess it made a great deal of impression on my mind at the time, that you are told that the labels had been removed to Newman Street and taken away from the branches and therefore it was a suspicious circumstance that there were still considerable stocks of labels and cartons in the stock sheets at the branches. But when you come to read the paragraph on which this is based, it certainly fails to bear that inference. It says that the increase in the figures of 3rd August last is accounted for by the labels that had previously been included in the stock at branches having been transferred to the warehouse from the 3rd August last, and all medicines made for the firm are now made up at the warehouse and are labelled there instead of at the branches as hitherto. When you consider what is practicable in a business of this kind, it is obvious that that can only refer to proprietary medicines, and therefore there would still be labels and cartons and other kinds of medicines at the branches. £210—that is, an average of £30 for each branch—appears in the stock sheets. I cannot say that it was the duty of the defendants to know that that was too large an amount, nor do I know of any evidence that I can accept that there were not cartons and labels to that amount at these very branches, and therefore I cannot say that, even if they were to have asked questions about this, they would not have found that these stock sheets were accurate. It is for the plaintiff to prove his case, and certainly if those stock sheets were inaccurate, and it is not shown that they were, inquiry would not have led to any alteration of the report at all.

Now, passing from that, what would the consequences be of the negligence with regard to those suppressed liabilities? It is admitted and proved by the plaintiff's witnesses that down to the date at which they commenced their audit there is not one single entry in the books which would have shown the existence of those suppressed liabilities. Let me take one. Large repairs put down to one shop during the year, and the bill has been run up with a firm who dealt in these things to the extent of £279. No reference whatever was made to that in the

account. It was not paid by 3rd August. I confess for myself I cannot see how the defendants could have known those repairs had been done or that there was any outstanding account of the kind. There is no entry in the books. The witnesses of the plaintiff admit that unless the defendants had letter books put in their hands they could not discover that. One or two smaller liabilities which are said to be suppressed, amounting to £60 in all, could have been found out by subsequent entries in the cash books, if those entries were made at the time when they were examining the books. There is no evidence that they were made at the time when they were auditing the books, and therefore I really think the case with regard to negligence as to the suppression of liabilities breaks down; the plaintiff has not proved it, and has not brought it home. I assume, therefore, that, supposing the defendants had exercised a more suspicious caution, they would have found some of these errors, I cannot see anything which would have made them take the view of anything but mistakes. To a certain extent, the figures in the final report would have been altered, but, taking the only one as to which it seems to me there is any chance of holding the plaintiff's case proved (that is to say, the labels), it would have been something equal to or less than £210—£210 less than the actual amount of labels that were at these various branches. You generally find that there are some inaccuracies, and, in fact, in this case, on a trial balance sheet, it was found that there was something like £11 out, showing that there had been mistakes in the books; but if the figures had been corrected to that extent, can we, as a matter of law, when the plaintiff does not give evidence to that effect, conclude that that made the difference between his advancing the money and not advancing the money? I am perfectly satisfied that the burden is on the plaintiff to show that the consequences of the negligence of the defendants were that the report was so seriously altered—so seriously incorrect—that it would have made the difference between advancing the money and not advancing the money. I can see nothing which would justify us in drawing that conclusion as a matter of law, which is a conclusion of fact really, for saying that the possible correction which would have been made by what I have called a suspicious caution would have altered the report to such an extent that we would say that the loss the plaintiff has suffered was in consequence of the negligence of the defendant.

For these reasons I think that the plaintiff has failed to prove his case. What I think he believed he had proved was this: that the defendants ought to have discovered that there was fraudulent alterations in the books. In the first place, it seems to me that with regard to the labels he has not proved that there were any false entries at all. With regard to the suppressed liabilities, I do not think that, with the exception of that £60, he has proved that there was any negligence whatever in not discovering the liabilities, but I am perfectly certain that there is no evidence to support the theory that the omission of two liabilities, amounting together to £62, ought to have made him suspect that there was fraud at work. I have not the slightest doubt that, unless we were to hold that he was bound to report that fraud was at work, nothing is proved to have resulted from any even hypothetical negligence of the defendants which we ought to consider would have prevented them going on with the scheme and advancing the money. For these reasons I think the appeal must be dismissed.

LORD JUSTICE FARWELL: I am of the same opinion. We have not heard Mr. Sankey, and therefore in what I say I merely assume, of course, without saying that it is the fact, that, as far as regards the examination of the stock account, there was something to put the auditors on inquiry. Certainly when I examined them myself, they did appear to me to have some very odd looking entries. I will assume, therefore, that they ought to have made some inquiry, but then, as the Lord Chief Justice says, it is to my mind perfectly astonishing that in this case the plaintiff has not made the slightest effort to show that in fact any single item of stock was not at the shops at that time. What is the result? If they are put on inquiry, the plaintiff has next to show, if they had made proper inquiries, something would have resulted which would have affected their report. He stopped short of that, and has failed to do it altogether. Certainly, with regard to all the items that we have heard of, I can find nothing to show that there was anything actually wrong in the accounts which we have seen, or in the report which was made ultimately by the auditors.

Then, as regards the liabilities which are said to have been suppressed, the Lord Chief Justice finds, as a fact, 'it has not been proved to me that there is a single entry in the books of the company which did come before the accountants, or any document that must have come before the accountants, which showed that those items had been included. I find as a fact, and I believe the statements so far as they touch this point of the defendants' witnesses, that they did not see the entries'. Looking at the accounts for myself, and judging as well as I can, it seems to me to be perfectly possible, and how the auditors could be held liable for not having discovered something from entries not existing at the time they examined the accounts, I fail to see. The case limps up to that point, but it breaks down entirely when you come to this, that the plaintiff went into the box and did not say that he had, in reliance on the report, made advances which he would not have made otherwise, and it appears to me for a very excellent reason, because he could not have justified it by giving any reason. If he had been cross-examined, what possible grounds could he have suggested for being deterred by anything that the auditors did or failed to do to prevent his lending the money? The real truth of the matter is that it all came out of the confession by Kingston, which, of course, is not evidence at all in this action as against this firm; it has nothing to do with them. A man years afterwards writes a confession to the company of misdeeds which he says he committed in the matter of the accounts of the company, and also before the company's existence. Well, it may or may not have been true; I do not know. But, at any rate, there is no evidence against the defendant firm, and I have very little doubt that Mr. Mead would have had to admit, in cross-examination, that it was by reason of that fraud, which he had got into his mind had been committed, that something or other, if they had examined further, would have been discovered by the auditors. I can only say that it is a ground which has not in any way been proved, and which ought not to be regarded by the Court as having any bearing on the subject.

I agree with what my brothers have said on the details, and I will not go through them again. I agree the appeal should be dismissed.

Mr. Sankey: The appeal will be dismissed with costs, my lord?

The Master of the Rolls: Yes.

CUFF v. LONDON & COUNTY LAND & BUILDING CO. LTD.*

(Decided by FARWELL and KENNEDY, L.JJ., in the Court of Appeal, on 5th February, 1912)

Held that when auditors have been refused access to the books of a company on the grounds of alleged negligence, the Court will not interfere by granting a mandatory injunction.

This was an appeal by the defendants from the decision of Mr. Justice Eve on a motion by the plaintiffs, as auditors of the defendant company, for an order giving them access to the books of the company and such information as might be necessary for the performance of their duties as auditors.

In March, 1910, the company, which carried on business as owners of land and buildings, appointed the plaintiffs' auditors, to hold office until the next annual general meeting, they having filled the office for many years previously. In June, 1911, the secretary of the company died, and it was then found that he had defrauded the company of a considerable sum representing rents treated by him as being in arrear. The directors alleged that the fraud of their servant was largely due to the negligent character of the auditors' investigation of the books, and in July last they intimated to the plaintiffs that proceedings would be instituted against them for negligence, which proceedings were delayed only until the actual loss was ascertained. The directors also suggested that the plaintiffs should resign.

The plaintiffs denied liability and refused to resign, and further claimed to exercise their statutory right of access to the books. The directors refused to recognise this claim, and the plaintiffs brought this action for a declaration in accordance with such claim, and moved at once by way of an interlocutory application for an order giving them access to the books.

Mr. Justice Eve granted a mandatory injunction in the terms of the notice

* [1912] 1 Ch. 440; *The Accountant* L.R. [1912] 13.

of motion, but allowed a stay in view of an appeal in the event of the defendants giving notice of appeal within seven days.

Subsequently the directors issued a notice to the shareholders expediting the general annual meeting of the company, which in the ordinary course would be held in March. By this notice the meeting was to be held on the 8th February, 1912.

JUDGMENT

The Court allowed the appeal.

LORD JUSTICE FARWELL said that in his opinion the order of Mr. Justice Eve could not stand. This was an interlocutory application of an unusual character.

The plaintiffs were the auditors of a public company, and they were charged by the directors, by way of suggestion, with having been guilty of negligence in not discovering that the late secretary of the company had been defrauding the shareholders through failure to inspect the counterfoils of a book of receipts for rent. This was only a suggestion on the part of the directors, but the fact that the counterfoils had not been inspected by the auditors was not disputed. The directors told the auditors that their further services were not required, and that they were not to come any more to act as auditors. The auditors now claimed to be entitled to have access to the books of the company for the purpose of auditing the accounts. It looked *prima facie* as if they were attempting to obtain discovery to help them in the action for negligence which the directors were threatening to bring against them.

The argument put forward on the part of the plaintiffs went to this extent, that an auditor of a company, even if he were a convicted felon, had a statutory right to have access to the books of the company of which he could not be deprived. Even if that were so, it was one thing to affirm such a statutory right and it was another thing to say that the Court would grant a mandatory injunction to give effect to such a right. He thought the usual practice of the Court when such a case arose was to direct that a general meeting of the shareholders should be held in order that their wishes might be ascertained. If the shareholders expressed the wish that a particular person should not act as auditor, the Court certainly would not force that person upon them.

Section 112 of the Companies Act, 1908, conferred the power of appointing an auditor or auditors on the company. An auditor so appointed had a *prima facie* right to rely on such appointment, and if he were discharged without cause the remedy of bringing an action for wrongful dismissal was open to him. But to say that he could force his services on a company which did not wish for them appeared to be extravagant. They now knew, though the learned judge when he took off the stay did not know, that a general meeting of this company was going to be held next Thursday. He did not see any real difficulty with regard to Section 113 of the Companies Act. That section said that every auditor of a company should have a right of access at all times to the books of accounts and vouchers of the company. But if an auditor were excluded *vi et armis* from the offices of the company, he could not be blamed for not performing a duty which he was manifestly unable to perform. At any rate there seemed to him to be no reason for interfering in this case in a summary manner, or for making an order which appeared to be asked not in the interest of the company, but in the interest of the plaintiffs themselves. The appeal must be allowed.

Lord Justice KENNEDY concurred.

CHANTREY, CHANTREY & CO. v. DEY*

(Decided by Mr. Justice WARRINGTON in the Chancery Division on 27th June, 1912)

Held that the right to publish or republish an auditor's report is a question of copyright law

* This was an action brought by Messrs. Chantrey, Chantrey & Co., a firm of accountants, for an injunction to restrain the defendant, Thomas Henry Dey, a bookmaker of Old Bond Street, from publishing, printing or circulating any copy of a certain report dated 2nd January, 1911, or any advertisement containing

* *The Times*, 28th June, 1912.

a copy of or extract from the said report, also for an injunction to restrain the defendant from issuing any advertisement or circulars calculated to lead to the belief that the report was made for the purpose of the defendant's bookmaking business.

The defendant had carried on his business as a bookmaker for many years, and in or about the month of December, 1910, he proposed to add to the business of bookmaker that of an outside stockbroker. To a considerable extent he advertised the outside stockbroking business in various London newspapers, including the weekly newspaper known as *The Looking Glass*. Another newspaper, known as *M.A.P.*, thereupon published an article deprecatory both of T. H. Dey and of *The Looking Glass*. The editor of *The Looking Glass*, Mr. West de Wend Fenton, was anxious to publish in his newspaper an article answering that in *M.A.P.*, and in particular for the purpose of that answer he desired to publish a statement by his own auditors as to the securities possessed by the defendant, with the object of establishing that he, as the editor of *The Looking Glass*, was not supporting either directly or indirectly an insolvent person trying to impose upon the public. Accordingly Fenton instructed the plaintiffs to examine the securities possessed by the defendant, and to make a report, and it was perfectly well known by the plaintiffs that that report was to be published in the next number of *The Looking Glass*.

The plaintiffs made their examination of the defendant's securities, and issued the following report:

'To West de Wend Fenton, Esq.

2nd January, 1911.

'Dear Sir,—In accordance with your instructions, we attended at the office of Mr. T. H. Dey on Friday last and inspected and verified his cash balances, the securities registered in his name, and the bonds deposited at his bankers. We found that the total amount of such securities and bank balances at the medium prices, where the securities are quoted on the Stock Exchange, or in any available lists, to be £72,873. In nearly all cases the values of the stocks have been ascertained from books and publications, but in a few cases we have had to estimate the value. There were also certain deeds at Mr. Dey's bankers relating to house property, reversions, and a bill of sale, which were produced to us for inspection.

'Yours faithfully,

'CHANTREY, CHANTREY & Co.'

In *The Looking Glass* for 7th January, 1911, there appeared an article headed 'Mr. Thomas Henry Dey', which concluded with the report made by the plaintiffs. The plaintiffs sent in an account to Fenton for the work done by them, which included attending and inspecting the defendant's securities and reporting to Fenton thereon. The defendant some time after paid the plaintiffs' account with his own cheque. In the meantime the defendant had asked the plaintiffs for a second copy of the report, but they answered that they could not without the express authority of Fenton send documents addressed to him to third parties. The plaintiffs also wrote to Fenton stating that they had received the defendant's request for a copy of the report, and stating that they could not send it without his express authority. In *The Looking Glass* of 22nd July, 1911, Dey published a full-page advertisement, and in that advertisement he published the plaintiffs' report to Mr. Fenton.

On 27th July, 1911, the plaintiffs were duly registered as the proprietors of the copyright in the report, and after some correspondence this action was commenced, and now came on for trial.

JUDGMENT

Mr. Justice WARRINGTON, in the course of his judgment, said that it was contended on behalf of the defendant that the plaintiffs were employed to write this report as a portion of the periodical called *The Looking Glass* and that they had been paid for it on the terms that the copyright should belong to the proprietor, and that they had been paid by the proprietor for that portion of the article, and that accordingly the copyright was vested in Fenton, and that, therefore, the plaintiffs were not in a position to sue the defendant, who admittedly had infringed the copyright.

His lordship, after referring to the provisions of the Copyright Act, 1842, and the authorities, said that he had come to the conclusion that the sole and exclusive liberty of publishing and multiplying the report had passed to Fenton and that the plaintiffs had not reserved to themselves the right of separate publication, and therefore that the action failed and must be dismissed with costs.

In re REPUBLIC OF BOLIVIA EXPLORATION SYNDICATE LTD.*

(Decided by Mr. Justice ASTBURY in the Chancery Division on 2nd December, 1913)

Held that company auditors are bound to know or make themselves acquainted with their duties under the company's articles and under the Companies Acts; and if the audited balance sheet does not show the true financial condition of the company and damage is thereby occasioned the onus is on the auditors to show that this damage is not the result of any breach of duty on their part.

Auditors are prima facie responsible for ultra vires payments made on the faith of their balance sheets, but whether and to what extent they are responsible for not discovering and calling attention to the illegality of payments made prior to the audit must depend on the special circumstances of each case.

Mr. Justice Astbury delivered a reserved judgment in a case relating to the affairs of the Republic of Bolivia Exploration Syndicate Ltd., in which the duties of auditors were brought into discussion. The liquidator of the company took out a summons against Messrs. Thomas Hewitt Myring, Ricardo Edward Lembcke, Paul Edward Vanderpump, Arthur Edwin Woodington, and William Norman Bubb. Myring, Lembcke and Vanderpump were directors of the company and Woodington and Bubb were the auditors. The three directors, for various reasons, fell out of the summons, and the summons proceeded against the auditors. The summons claimed certain sums in respect of the alleged misfeasance of the auditors, or negligence or breach of trust in passing and certifying in the accounts of the syndicate various payments appearing there which were alleged to be wrongful payments by the company in respect of commission and profit costs. The payments were: £330 10s., paid as commission to Thiew and Scott; £160, profit costs paid to Vanderpump; and £36 retained by Myring and not accounted for by him.

JUDGMENT

His lordship said: This is a misfeasance summons by the liquidator of the company, which was brought originally against Myring and Lembcke; the solicitor, who was also a director, of the name of Vanderpump; and the two auditors, Messrs. Woodington and Bubb, seeking to make the first two respondents liable for very large sums retained by one or other of them in connection with the company out of its assets; seeking to make the solicitor liable for profit costs; and the auditors liable in respect of certain payments which I will deal with in a moment. The two directors were also charged with the same sums as are sought to be recovered from the auditors.

Now, the present respondents who remain are the auditors, with whom I have alone to deal. A consent judgment has been taken against the respondent Myring. The respondent Lembcke has escaped liability on the ground of diplomatic privilege, and the solicitor Vanderpump is dead. The company was incorporated in March, 1907, generally to acquire mining property in Bolivia. In the absence of special articles, Table 'A' applied, and the directors obtained, therefore, no power under the company's regulations to contract with the company. Myring and Lembcke were appointed directors by signatories in March, 1907, and Mr. Vanderpump was appointed solicitor to the company at the same time. In May, 1907, a very extraordinary contract was entered into between Myring and the company, reciting that Myring was about to proceed to Bolivia for the purpose of taking up certain gold mining property already prospected on his behalf and of prospecting and acquiring others, and provision was made for the payment of his expenses of going out to Bolivia, without requiring any voucher from him in respect of the expenses, and the consideration mentioned in the contract was

* [1914] 1 Ch. 139; XLIX, *The Accountant* L.R. 61.

£20,000—£5,000 in cash and £15,000 in shares. On 14th June, 1907, Mr. Vanderpump was appointed a director. On 29th November, 1907, a second agreement was made with Myring, confirming the first one. The present respondents were appointed auditors of the company, I think on the same date—at all events in November, 1907. Now the minutes of the board meeting of 13th December, 1907, refer to a payment of the company's solicitor of £100, balance of agreed costs of incorporation. This sum was paid by cheque to the solicitor, signed by himself and Myring. The minute of the meeting of 16th March, 1908, contains a resolution that a commission of 10 per cent. in cash be paid to a Mr. Thiew, of the Devonshire Club, for introducing subscribers for shares. This gentleman is not shown to have been a subscriber, nor did the company in connection with the payment subsequently made in respect of this commission comply with the requirements of Section 8 of the Companies Act, 1907.*

Myring and Lembcke left England for Bolivia in March, 1908, on what proved to be a wholly abortive attempt to either locate or obtain any title to either of the mining properties referred to in the agreement with the company. On 14th December, 1908, the first ordinary general meeting of the shareholders was held, when the first of the two balance sheets of the company, which were audited by the respondents, with the note appended, was produced. Adverse criticism of the accounts took place at this meeting, which was consequently adjourned, but the balance sheet and accounts were adopted at the adjourned meeting, which took place on 22nd April, 1909. On 17th March, 1910, the second general meeting took place, when the second of these balance sheets was adopted. The respondents, the auditors, were not re-elected, and ceased as from this date to be officers of the company.

There are four claims made against the respondents, the auditors, as follows: First, for the payment of two sums—£329 10s. and £9—paid for commission for placing shares under the above-mentioned resolution 16th March, 1908; secondly, for £150, the agreed profit costs received by the solicitor-director Vanderpump in an amount of £250 paid to him for costs of incorporation of the company; thirdly, the sum of £50, the agreed profit costs received by the same gentleman out of the sums paid to him in respect of rent, clerical work and further costs; and, lastly, £36 3s. 8d., the balance of a cheque drawn by the company in favour of the Army & Navy Stores or bearer, received by Myring and not accounted for. None of those moneys were paid by the company or its directors in consequence of any report or audit made by the respondents; but it is contended by the liquidator that they failed in their duty in passing those accounts with these sums contained in them without drawing attention to the fact, and they were wrongful payments under the circumstances, and that the balance sheets which included them did not in consequence show the true financial position of the company; and that damage accrued to the company in consequence of such alleged breach of duty.

I will deal with the audited balance sheets and what they contain. They are, as I said, two—the first for the period ending 30th November, 1908. This shows £20,000 paid to Myring, and then it contains the following item: 'Preliminary expenses for the incorporation of the company, duty, fees, and other disbursements, £250.' That is the sum in respect of which the £150 claim for profit costs is made. The next item is, 'Commission paid for obtaining subscribers for shares, £338 10s.', and then there are various sums paid to Messrs. Vanderpump on account of law charges and office and general expenses detailed as in the account; and then there is a sum of £7,381 odd stated to be 'moneys paid to Mr. Myring for the purchase of stores, plant and outfits, and to be disbursed by him in Bolivia as per agreements with the company'. Then the auditor's note is: 'We have obtained all the information and explanations we have required. In our opinion such balance sheet is properly drawn up so as to exhibit a true and correct view of the company's affairs, according to the best of our information and the explanations given us and as shown by the books of the company.' The second balance sheet is for a period ending 28th February, 1910. That contains, as far as the present case is concerned, the same items, but at the foot of the balance sheet is the following note: 'We have to report that the first three items on the assets side are stated in exactly the same form as on the last balance sheet'—that is, the £20,000, the £250, and the £338—'adopted by the shareholders; and the only

* Substantially re-enacted in Section 53 of the Companies Act, 1948.—Ed.

voucher we have seen for Mr. Myring's outlay and expenses, amounting to £6,781 3s., has been a copy of an account signed by him; and that the £1,310 charged against Mr. Lembecke has been paid and remitted to him; but no account of this expenditure has yet been rendered. With these qualifications we report that we have obtained all the information and explanations we have required, and in our opinion such balance sheet is properly drawn up', and so on.

Mr. Woodington, one of the respondent auditors, has given his account of his conduct as auditor in an affidavit, upon which he has been cross-examined before me, and the result of his evidence is as follows: First, as to moneys paid for commission. Mr. Woodington attended the shareholders' meeting in December, 1908. His attention was called to this item: 'And it was alleged to have been an improper payment.' Mr. Woodington said at the meeting that it was a matter for the shareholders to sanction or not, that he had no power to surcharge, and could only show what had become of the money. Mr. Woodington admitted to me that he knew there were provisions in the Act as to underwriting commissions, and that there must be authority in the articles to pay them; but he says that when he saw the payments in the books he looked at the memorandum to see if there was power to pay such commission, and he found it there, as is the fact. No further mention was made of the matter, and the same item was entered and passed in the second balance sheet as above-mentioned without further inquiry or investigation.

As to the £150 profit costs received by Mr. Vanderpump, Mr. Woodington says that the payment of the bill of which this forms part was authorised by the directors as appearing in the minutes; but he never inquired whether, excluding Mr. Vanderpump, there was a quorum present at the meeting authorising it. He says that a voucher was produced to him, and that it never suggested itself to him that it was part of his duty as auditor to decide whether the payment was legally proper or not—that he saw the minute of 14th December, 1907, referring to the agreed costs of incorporation, which agreement, he presumed, was made before Vanderpump became director. He never asked for the agreement, and it did not occur to him that there was any difficulty in a solicitor-director making a profit. He could not say whether he saw the cheques given in payment. The receipts which he saw for the money appear to refer to directors' meetings, the dates of which are wrongly given, but he made no further inquiry or investigation with regard to it. As to the £50 further profit costs made by Mr. Vanderpump, Mr. Woodington says in his affidavit. 'The whole of the items making up the said sum, with the exception of the last three'—that is referring to a total sum of which this is part—'were expended before my said firm had been called upon to act as auditors for the company, while the last item—£15 3s. 3d., of 19th September, 1911—is after my firm had ceased to be auditors, they not having been re-elected at the second ordinary general meeting held on 17th March and—by adjournment—30th June, 1910. All the said payments made during the period of my auditorship were authorised or ratified by resolutions of the board of directors, and appear clearly in the books of the company.' He says, with regard to those payments, no objection to the same on the ground of illegality was raised at any of the meetings at which he was present, and he states he is not competent, nor does he consider it part of his duty as auditor to tax a solicitor's bill of costs. With regard to the last item of £36 odd, Mr. Woodington states that this amount is the balance of a sum of £100 paid to the respondent Myring by an open cheque made payable to the Army & Navy Stores or bearer, handed to and cashed by Myring, and that he has acknowledged the receipt of the same, and that the full amount of the cheque forms part of the sum appearing on the asset side of the balance sheet in the items I have read.

In support of the liquidator's contention on the above facts, it is alleged that *qua* company finance, of which they profess to be experts, auditors must at least make themselves acquainted with the general features of such legal regulations as govern the methods and restrictions as to limited companies' accounts and finance; and that the accounts as audited by them must correspond with the reality in law of the company's financial position; and that damages must be assumed to have resulted in this case from its not having been pointed out in time the directors were liable to refund those moneys.

Now there are some legal matters which an auditor must obviously know, as there are others which it is equally obvious that he cannot be held responsible for not knowing, and it may not always be easy to say in which category any particular case falls. I think that auditors of a limited company are bound to know or make themselves acquainted with their duties under articles of the company whose accounts they are appointed to audit and under the Companies Acts for the time being in force. And that, when it is shown that the audited balance sheet did not show the true condition of the company, and that damage has resulted, the onus is on the auditors to show that this is not the result of any breach of duty on their part. The authorities, however, are not very clear as to what, if any, is the liability of auditors of a limited company for including or passing in accounts audited by them sums paid by the company or its directors prior to the audit and which, by reason of the want of authority in the regulations of the company, or non-compliance with some statutory provision of the Companies Acts, ought not in the particular circumstances to have been paid; nor, if any liability would otherwise exist, what is sufficient by way of warning or identification in the audited accounts for the necessary information to be expressly conveyed by the auditors to the company in order to free them from further responsibility.

Applying the principles in the authorities as best I can to the facts of the case, I have arrived at the following results: First, as to the sums improperly paid for commission for obtaining subscriptions for shares, I am not satisfied that the respondents failed in their duty to the company in not knowing or ascertaining that the payments were under the circumstances improper in law before they passed them in the first audited balance sheet, especially having regard to the fact that the balance sheet states in terms for what the sums in question were paid. After they learned at the shareholders' meeting of 14th December, 1908, that the legality of those payments was questioned, the meeting was adjourned for the purpose, *inter alia*, of inquiries being made into the matter, and the balance sheet and accounts were subsequently approved by the shareholders at the adjourned meeting, and I do not think that they ought to be held guilty of breach of duty for passing the same entry as to these sums in the second audited balance sheet; nor do I think that, having regard to the fact that the shareholders approved them after discussion, as above mentioned, that the liquidator has established that any damage resulted to the company from the auditors having acted as they did.

As to the sum received by the solicitor-director Vanderpump for profit costs, the position of the respondents seems to be more doubtful. Mr. Woodington has admitted in the box that he made no inquiries beyond asking for and being shown the receipts for payment; but, having regard to the fact that as to the payment of the £250 the minutes stated it to be part of an agreed sum for the costs of incorporation; and as to both the sums claimed in respect of profit costs that Mr. Vanderpump was not appointed a director until three months after incorporation; and to the question as to how far the auditors were bound to ascertain that in this company no authorisation existed for directors to contract with the company and to appreciate that the profit costs of the solicitor's bill were subsequently authorised in law, I do not think I ought to make any order for payment of these sums by the auditors, although I am far from satisfied with the way in which this part of their audit was conducted. I may add further that I am not satisfied that the shareholders would in this case, any more than in the case for commission for placing shares, have taken any proceeding against the directors if this question had been expressly placed before them by the respondents, failing which no damage would have resulted to the company from their action. As to the sum of £36 3s. 8d., the bearer cheque for £100 was, together with other large sums, handed to Myring for the purchase of stores, plant, &c., and the whole of the £100 was entered in the audited balance sheet under this heading, with the note appended to the second balance sheet which I have read, and I see no sufficient ground for charging the auditors with any breach of duty as to this.

The result, therefore, is that I do not propose to make any order against the auditors in this summons, but, having regard to the general manner in which the

audit was conducted, and to the evidence of Mr. Woodington himself, I dismiss the summons against the auditors without costs.

Mr. Clauson: I take it your lordship will allow the liquidator his costs of the summons as against the auditors out of the assets?

His lordship: Yes.

Mr. Clauson: And also his costs against Mr. Lembcke


His lordship: Yes, I think both of them were perfectly proper cases.

Mr. Clauson: The summons was directed against Mr. Vanderpump, and, of course, became abortive when Mr. Vanderpump died. Your lordship will allow the liquidator the whole costs of the summons?

His lordship: Yes, I think the whole summons was a proper and justifiable summons.

COLMER v. MERRETT, SON & STREET*

(Decided before Mr. Justice LUSH and a special jury in the King's Bench Division on 15th January, 1914)

 *A case of some importance, raising the responsibility of an investigating accountant for failure to discover errors in the books*

This was an action brought by Mr. George William Colmer, an engineer, residing at Bourne End, claiming damages for alleged negligence from the defendants, Messrs. Merrett, Son & Street, chartered accountants, of 41 Finsbury Square, London. The defendants denied they had been guilty of any negligence.

Mr. Holman Gregory, K.C., and Mr. McCardie appeared for the plaintiff, Mr. Disturnal, K.C., and Mr. Doughty represented the defendants.

Mr. Holman Gregory, in opening the case, said it related to a firm of F. Bradley Ltd., who carried on business at Twickenham and at Argyll Place, Regent Street, London, as manufacturers of motor bodies, motor-car agents, and dealers in motor accessories. In 1910 Mr. Colmer, the plaintiff, was induced to invest some £2,500 in this company, which he did after inquiry had been made by the defendants and a report made by them upon the business conducted by the company. He was advised by defendants that the business was a sound one, and was making profits, but it was discovered after a short time that, instead of it being a flourishing concern, it was worked at a very serious loss. The result was that the plaintiff lost all his money except £300. He now said that had the defendants exercised due skill and diligence in the inquiry they undertook into the business they would have discovered that it was a losing one, and he would not have invested his money. That was a short outline of the case.

Going into greater detail, counsel said F. Bradley Ltd. came into existence in April, 1909. Some time after February, 1910, an audit was made and a balance sheet was prepared for the nine months the company had been trading. Mr. F. Bradley was the managing director of the company, and Mr. H. C. Merrett, the senior partner of the defendant firm, was a shareholder in it, and apparently took considerable interest in its progress. The defendant firm were also auditors of the company, and the balance sheet down to 28th February, 1910, was prepared by them. That balance sheet set out that there had been a profit made for the nine months' trading of about £700. In fact, that was wrong, and instead of the company having worked at a profit they had lost £600. Items were put in as stock-in-trade up to nearly £1,400, which did not exist, and that converted the loss of £600 into a profit of £700.

Following that date, apparently Mr. Bradley wanted more capital for the business, and in April Mr. Maurice Kemp-Welch was induced to come in and purchase a certain number of shares and become a director. The plaintiff had been a partner in an engineering business, and having sold his interest and having two or three thousand pounds, was anxious to acquire an interest in another business connected with engineering. He was introduced to Mr. Merrett, who told him he thought he knew of a business in which Mr. Colmer might safely invest, and he introduced him to Mr. Bradley. Apparently Mr. Bradley still wanted money after he had obtained £2,000 from Mr. Kemp-Welch. There was a discussion on the terms of which Mr. Colmer was to put money into Bradley Ltd., and it was

* *The Accountant* L.R., Vol. L, p. 21.

suggested that plaintiff should become managing director with Mr. Kemp-Welch and Mr. Bradley, that he should receive £6 per week out of the business, take up 1,692 $\frac{1}{2}$ shares at a premium of 2s. 6d., and further advance to the company by way of loan the sum of £1,101 10s. These odd sums were apparently arrived at in order that the three directors should be put in the same position. When the terms were discussed, Mr. Colmer consulted Messrs. Kingsford, Dorman & Co., solicitors, and asked Mr. Moore, a partner in the firm, to look after his interests. Mr. Moore advised him it would be unwise for him to invest his money until he had seen a balance sheet of the trading down to the last stock-taking and until a firm of chartered accountants had examined the books. On 18th November, 1910, there was an interview between Mr. Moore and Mr. Colmer on one side and Mr. Bradley and Mr. Merrett on the other. Mr. Moore had seen the balance sheet made up to the previous February, and that the audit had been made by Mr. Merrett's firm, and said to him, 'You know all about this business. You could go through the books for Mr. Colmer and ascertain the true position of the business perhaps more expeditiously than strange accountants.' Mr. Merrett agreed to do so, and it was eventually arranged that for a fee of ten guineas Mr. Merrett should go through the books and accounts and prepare an approximate balance sheet up to 31st October, 1910. It was also arranged that stock-taking should be undertaken, and that Mr. Merrett should supply a report and balance sheet as early as possible.

Mr. Merrett got out a balance sheet with figures showing that the business from 28th February down to 31st October had been worked at a profit of over £1,363. He put £363 to a reserve account, and then said the surplus for the eight months was £1,000. The report and balance sheet were sent to Mr. Moore, and he then saw Mr. Merrett, who told him that the business was one of the soundest in London, and that it was quite safe for Mr. Colmer to invest in. Thereupon an agreement was drawn up between the company and Mr. Colmer, by which the latter eventually invested £1,903 10s. in respect of the 1,692 shares and lent a sum of £346 10s. In a month or so the plaintiff began to suspect there was something wrong with the business, and that it was not being carried on at a profit. He commenced to make inquiries and unpleasantness arose between himself and Mr. Bradley and between Mr. Kemp-Welch and Mr. Bradley, with the result that Bradley suggested that these two gentlemen should sell their interests in the business, and that he would find someone who would buy them out.

After some discussion an agreement was come to between the company and Messrs. Colmer and Kemp-Welch, under which both of the last-named were to sell their interests and walk out of the business. The terms made with Mr. Colmer were that the company should repay the £346 that had been lent and pay £511 10s. compensation for the determination of the agreement (under which Mr. Colmer had been appointed managing director at £6 weekly), and that Mr. Bradley should purchase the 1,692 shares at £1 each. It was found that the company could not raise the money to pay the sums of £346 10s. and £511 10s., and three months later there was a further agreement by which debentures were issued by the company, and certain assets were handed over to Messrs. Kemp-Welch and Colmer. One of the provisions of the debentures was that they should become payable and that a receiver might be appointed by the two debenture-holders if at any time the book debts of the company should be less than £2,500. It was not very long before the book debts were found to be less than this figure, and during all this time there was no doubt the company was trading at a very serious loss.

A month or two after the debentures were issued—viz. upon 5th August, 1911—a receiver was appointed for the debenture-holders. When the receiver, Mr. H. E. Sier, entered into possession he quickly discovered the true state of affairs, and found that from April, 1909, when the company began, down till June, 1911, they had traded at a loss of over £6,000. Of course, they could not go on, and the receiver then started to realise the assets for the benefit of the debenture-holders. He tried to get someone to buy the business as a going concern, but could not do that. He then had a valuation made of the machinery, &c., and the office furniture. Only one person sent in a tender for the furniture. The debenture-holders were placed in a very serious position, and eventually Mr. Colmer made a suggestion to a Mr. Harrison that he should join him in the formation of a small company who should buy up the assets and endeavour to make use of them. The plaintiff

made an offer through his solicitors of £600 for the assets, and that was accepted by the receiver, and so eventually the estate was wound up. Mr. Colmer received back from the receiver in cash £306, being his share of the assets realised by the receiver. The result was that the plaintiff had lost upwards of £2,000 over the venture.

If Mr. Merrett, or his assistant, went on counsel, had exercised due skill and diligence, he would have ascertained the loss which had been made up to February, 1910, and that the balance sheet then made was misleading and wrong. The figures which purported to show a trading profit of £700 for the nine months were fallacious, inasmuch as they allowed for there being stock at Regent Street of the amount of £1,800, whereas there was not that amount, or anything like it. To arrive at that figure two motor chassis had been included, a Mercedes at £941, and an Austin at £466, making a total of £1,497. These were not upon the premises at all, but Mr. Merrett alleged that they were in the bought ledger as having been purchased by the firm. That was true. But Mr. Merrett, or whoever prepared the balance sheet, treated these two motors as being part of the stock of the company, whereas all the time he was doing this it appeared in the sales ledger that these two chassis had been sold a day or two after the date of purchase. Assuming, continued Mr. Gregory, that Mr. Merrett had been told that there were these chassis in stock, it was nevertheless his duty to check them, otherwise it was of little use having an audit. When he found in the sales book that the two chassis were sold a day or two afterwards, there could be no doubt it was the duty of the auditor to make inquiries. All this time Mr. Merrett's firm were checking the accounts monthly by arrangement, and apparently Mr. Merrett was attending at Regent Street and advising Mr. Bradley. During these nine months there were only sixteen chassis dealt in altogether, and it was not therefore a question of there being a multiplicity of figures.

With regard to the second balance sheet, there was something very startling. From this it would appear that the company had been trading at a profit of something like £1,300. In fact, during that time there had been a loss of over £1,700, a difference of £3,000. Accountants would be called who would say that if any person had looked at the figures with ordinary diligence the difference must have been discovered. It was called an approximate statement of affairs up to 31st October, and upon the asset side there appeared the item, 'Debtors—trade, £4,744'. That figure was inaccurate, and the correct amount was £2,560, an inflation therefore of over £2,000 in one item. In regard to this there was a sales ledger in which sales by the company were set out, and in the last month (October) it appeared the sales were very much larger than for the preceding month. If there had been a comparison between the sales and the bought ledgers it would have been found that when the company was contracting to sell certain motor-cars they had not bought them, and when they carried out the transaction later they bought the motor months afterwards from the manufacturers. To give an instance of that, there figured among these trade debtors for £4,744 a Rolls-Royce chassis at the price of £985. It was set out in the sales ledger that this sale had been made. As a matter of fact, there was nothing in the bought ledger that such a car had been bought, and it had not in fact been bought. The chassis that was delivered under the contract was not purchased until 27th January, 1911, months afterwards. That account was therefore wrong to the tune of £985.

As another instance, said counsel, there was the banking account of the company. The cash book showed that upon 31st October F. Bradley Ltd. were overdrawn to the extent of £198, but in the balance sheet prepared by Mr. Merrett there was £266 cash at the bank. Again, there was the account of a Mr. Skidmore. The gentleman who prepared the balance sheet to October, 1910, gave credit by the payment of £119 as having been made before 31st October. In fact, that payment was not made until November, as appeared by the books. A further instance he would mention, said counsel, was a sum of £41 received on 19th October. For some reason or other it was not known from whom the money came. It was accordingly placed in the suspense account for the moment, and it appeared in the books as having been paid. When Mr. Merrett, or his assistant, was making up the balance sheet he set out against the debtors the full amount of their debt and did not give credit for this payment. If he was right in these instances, added

counsel, it wiped out this £1,000 profit and showed that the person who entered upon the audit never realised his position.

Mr. Disturnal said his clients took no responsibility for the stock at all, and they so stated in their reports.

Replying to a juror, Mr. Disturnal said Mr. Merrett held fifty shares in the company.

Plaintiff, giving evidence, said that when he saw Mr. Merrett the latter said that all particulars must be got through him.

Mr. Disturnal (cross-examining): Did Mr. Merrett say it would be better for him not to act for you, as his firm were already auditors to the company?

Plaintiff: I never heard it. If he did it was to someone else.

Did you and Mr. Bradley press him to act for you?—No, I would as soon have had someone else.

Did Mr. Merrett tell you he could not see his way to do it, and in any case it would be impossible for him to prepare the figures within the time you wanted them?—He said it would be an approximate statement. He might have said he could not get out a profit and loss account. I don't recollect him saying he could not get out the balance sheet.

He said the figures would be approximate?—Yes.

His lordship: Did you say you must have it within a definite time?—No; I only said I should like it as soon as possible.

Counsel: Did Mr. Merrett tell you it would be impossible to get out a proper balance sheet and profit and loss account in less than three weeks?—He might have said so.

Did you tell him that an approximate statement would be enough?—I did.

Did he say he would not be able to go critically into the books and check the statements in them?—He might have said that.

Do you suggest Mr. Merrett undertook to check the stock with Bradley?—I do.

His lordship: What led you to suspect this statement was inaccurate?—When I heard certain remarks by Mr. Skidmore.

What were you suspicious of?—There was a question of a cheque for £100 which did not seem in order.

Plaintiff, in further examination, said he purchased the assets of the company for £600 and then floated a small company to work the business. For the assets he took 3,000 £1 shares in the company, and Mr. Harrison, with whom he was associated, put in £600.

His lordship: He paid into the company the same amount to a shilling that you paid for the assets?—Yes.

The evidence of Mr. Moore, the solicitor, which had been previously taken, was then read. He said it was made quite clear to Mr. Merrett for what object the report of the business was required, and Mr. Merrett appreciated that stock would have to be taken for the purpose. He (Mr. Merrett) said afterwards that he had taken the figure of the stock from Bradley.

His lordship: Do I understand the February balance sheet was not prepared at the request of the plaintiff?

Mr. Disturnal: No.

His lordship: Then I don't see any contractual duty in regard to it.

Mr. Holman Gregory: We say that if Mr. Merrett had properly conducted his inquiry for the balance sheet of October he must have discovered the mistake in the balance sheet of February. He ought to have observed that at once and told us about it.

His lordship: Assuming the February balance sheet was made with great carelessness, if that was over and done with there was no breach of duty towards the plaintiff. If the person who prepared it was asked by the plaintiff to prepare one in October I am sure he was negligent because he does not rip up the February one.

Mr. Gregory: There is no question of ripping it up.

Mr. Disturnal: It does not stop there. It is suggested that the blunder in the February balance sheet is in the stock. The question is, what is the stock in October? The statement as to the approximate stock in October is accepted, so I cannot see how any inaccuracy upon the stock in February could have been material to the statement of the stock in October when the statement in October was perfectly accurate.

The judge: If you accept the statement of the stock in October doesn't it become immaterial what the stock was in February?

Mr. Gregory: I do not think so.

Mr. Horace Evelyn Sier, Fellow of the Institute of Chartered Accountants, and partner in the firm of Viney, Price & Goodyear, of 99 Cheapside, said he was appointed debenture accountant in August, 1911. Shortly afterwards he became receiver of the company. In September, 1912, acting upon instructions, he made a comparison of the books of the company with the balance sheet to October, 1910, and found the latter inaccurate in a number of particulars. Instead of a profit of £1,363, he found a deficiency of £1,730 odd. He noticed that the sales for October were larger than in any of the preceding seven months, and that during the eight months there were only sixteen chassis dealt in. The books showed the sale of a Rolls-Royce motor-car on 24th October to a Mr. Gubbay for £985. There was no entry to show that the Rolls-Royce was in stock at the time, and there was no justification for treating that £985 as a debt to carry in as profit.

Counsel: Would an accountant preparing a balance sheet down to October refer to the balance sheet prepared in February?—Yes.

Would he look at the stock?—I should think so.

In the February balance sheet, continued witness, there was a profit shown of £700. That was on the basis of there being a Mercedes chassis and an Austin chassis in stock at the Regent Street premises. The books showed that these chassis were sold before February.

His lordship remarked that it did not help the plaintiff to rest his case upon the February balance sheet. The defendants were not employed by the plaintiff to get out that balance sheet.

Mr. Gregory: They ought to have traced out what became of these two chassis. Where you have two large items like that the auditor would look to see what had become of them and how they had been dealt with.

His lordship: What was there to show Mr. Merrett that these two large items ought to be accounted for?

Counsel: Your lordship will not forget that Mr. Merrett was the person who prepared this February balance sheet. He was not an absolute stranger.

Mr. Doughty (cross-examining): Do you suggest that when an accountant comes across an item in a sales ledger, when there is no reference to it by which he can find out where the material comes from, he must go and ask the manager of the business where he got the chassis from.

Witness: Not in the case of small items.

Do you suggest he ought with big items?—In items of outstanding importance.

Take Friswell's, who deal in a great many chassis?—I suggest that with them the sale of a chassis is not of outstanding importance.

If the chassis was entered in the bought ledger and was then actually on rail there would be nothing to show? You appreciate that?—Yes.

Isn't it the custom with auditors when preparing balance sheets to take the stock sheets from their principals?—Yes.

An auditor himself does not take stock?—That is so.

Witness mentioned the case of the Mercedes chassis, and said a careful auditor would go further than the stock sheets to see if the chassis had been sold with a view to testing the stock sheet.

Counsel: Do you suggest that the stock sheets which Bradley put forward comprising these two chassis contained an honest mistake?—I don't know. I haven't seen them.

But the stock sheets are some of the most material documents upon which a balance sheet is taken out?—Yes.

His lordship: Apart from this action, do you think that the February balance sheet was prepared without proper care?—I think there was negligence.

Counsel: Negligence in not checking the stock sheets?—Yes.

Have you taken the trouble to look at them?

Mr. Gregory objected to the question, as the stock sheets had not been in the custody of the witness.

Mr. Doughty: Have you ever asked for them?

Witness: No.

Or looked for them?—No.

You would have had no difficulty in getting them if you had?—I should.

I want to know what tests an accountant should apply when he takes stock sheets from the principal?—If there were a number of small items and then, say, three very large items, we should apply some tests to the large ones.

His lordship (to counsel): Take the case where a manager improperly hands to the auditor stock sheets containing items which do not exist. Do you say the auditor has no duty to test them?

Counsel: Absolutely none.

His lordship: The more likely you are to have fraud I should think the more careful the auditor should be.

Counsel (to witness): Do you suggest that all large items can be tested?—No. There are cases in which I have done so, but I do not suggest it always.

Do you say it is the absolute practice of an auditor, or that some do and some do not?—It is the general practice. I cannot go further than that.

Then some auditors do take certified stock sheets and rely upon them?—Yes, I have heard of it.

The judge: Is that the general practice?—No, I don't think so.

A juryman expressed the opinion that it was the duty of an auditor who was paid a fee of ten guineas to see that the stock was there.

Counsel: Do you know that when Mr. Kemp-Welch went into the business he employed accountants?—Witness: I have heard so.

How many hours have you and your assistant spent in getting out these figures?—I cannot say.

Isn't it a fact that you yourself first treated Mr. Gubbay as a debtor to the company for £795?—No.

To check all these things requires a great deal of time and care?—Yes.

You yourself in dealing with the figures have upon further investigation brought out the balances differently?—That is partly so.

That is the sort of thing you would expect every accountant to do who was not making a full audit?—Yes.

His lordship: There is no human creature who does not make mistakes without being negligent.

In re-examination the witness said it was true that some of the particulars upon the plaintiff's side had undergone alteration since the case began, but that was owing to further discovery of documents by the defendants. These alterations were only upon minor matters.

That concluded the plaintiff's case.

Mr. Disturnal, K.C., opening the defence, said it had been put to the jury as though Mr. Merrett had been a person largely interested in F. Bradley Ltd., and anxious to get people to put money into the business. That was not the position at all. Mr. Merrett had been only a nominal shareholder in this company, as he was no doubt in many others to which he was auditor. Except as accountant he was in no sense interested in the company. The charge against him was that he had been guilty of negligence and breach of duty towards the plaintiff. A mere mistake would not necessarily render a professional man liable to have damages awarded against him, because, if so, no one would undertake any such duty. If Mr. Merrett had undertaken to make a careful audit of the books of this company and go through them as an auditor might for the purposes of litigation or something of that kind, one might criticise his work more effectively and more fully. But he undertook nothing of the kind and only purported to give an approximate statement of the company's position. He acted throughout upon the statements furnished to him by Mr. Bradley, and in reporting to Mr. Colmer he said, 'I have extracted the balances from the bought and sold ledgers'. He did that, and did it right. His report continued, 'The accuracy of them I am unable to vouch for as owing to the short time at my disposal I have been unable to call for the statements from suppliers, or send out inquiries to debtors, but for your purposes you may take them as approximately correct. With reference to the stock, as arranged by Mr. Colmer, I have taken figures supplied by Mr. Bradley.' He went on to say that stock amounted to so much, and that was the rough-and-ready kind of thing he had undertaken. There were pages of debtors in the ledgers and there were no balances because that was not the time of the year. He took every one of these accounts and made them up, doing so with very fair

accuracy. There was no doubt, said counsel, that the balance sheet to February 1910 was incorrect, but the mistake was not Mr. Merrett's. Mr. Bradley gave him the figures of the stock and they were embodied in the balance sheet. It had been said that items had been included as stock which were not there, but that was not a matter Mr. Merrett was concerned with. Subsequently accountants were employed by Mr. Kemp-Welch but they did not discover the inaccuracy, and the mistake was in fact not found out till 1911.

Mr. Henry Charles Merrett, one of the defendants, said in evidence that he was a Fellow of the Institute of Chartered Accountants. He was in partnership, and had been practising for seven years. Referring to the balance sheet to February, 1910, witness said he found out at a later period that the two chassis had passed out of stock. There was nothing to put him upon inquiry whether there were entries in the books which ought not to be there.

His lordship: If you take the sheets from the principal it would depend on the good faith or care of the firm?—Witness: Quite, unless you trip the man up.

If he is careful not to give you any indication?—Then you cannot find it out. You would do so ultimately.

Counsel: In your experience does an auditor make himself in any way responsible for the accuracy of the stock?—No.

Would it make the audit any more reliable if he simply arbitrarily took out a few items of stock from the bulk and endeavoured to check those?—No. You might pick upon good ones and leave out the very bad ones you were trying to discover.

Is it better in your opinion to leave that avowedly to the integrity and skill of the officials of the company?—Quite.

Witness said that between February and October he personally had nothing to do with the books of F. Bradley Ltd., but his clerks went once a month and checked the posting, &c. He was repeatedly pressed by Mr. Colmer to prepare a statement of the company's position, and at first refused, as he was already the company's auditor. He did not represent the business to the plaintiff as one of the best in London, or anything of the kind. He merely said he thought it had good prospects. On Saturday, 12th November, Mr. Colmer again asked witness to undertake the work and prepare a balance sheet and profit and loss account by the Monday night. Witness replied that he could not do so, and plaintiff said an approximate statement of affairs would do. That witness agreed to provide, and commenced the work on the same afternoon, plaintiff agreeing that an estimate of the stock by Bradley would be sufficient. In getting out the statement witness had to take the accounts of about 150 creditors and 100 debtors and balance every one, and the statement he got out was prepared to the best of his ability in accordance with what he had undertaken to do. He was now prepared to go into every account and justify inaccuracies where they appeared.

Cross-examined by Mr. Holman Gregory witness said he took no part in the formation of the company. It was not the rule for auditors to attend meetings of directors, but he attended some of this company's at the directors' request.

Counsel: Did you enter up the minutes time after time?—I dare say I did. They said they did not understand these various points and asked me to help them.

Did you from time to time advise Mr. Bradley in his business transactions?—I helped him with regard to a lease.

Did you go to the office two or three times a week?—I may have done so, but it was not to confer about business.

Did you take part in the negotiations with regard to Mr. Kemp-Welch coming into the company?—Yes, I did, on behalf of the company.

If in the last month an auditor finds extra heavy sales, isn't it his duty to ascertain whether they are in fact fictitious or bona fide?—No. I don't think so.

Is there no means of checking fictitious sales by audit?—Not unless you get accurate stock accounts.

His lordship: Is it the particular duty of an auditor to protect shareholders and other people by ascertaining as best he can whether these are fictitious or real sales?—No. You must take the word of a business man. It would be an impossible position if you had to check every sale that was made.

But when it is a case of one or two big sales just before the audit?—No. The only way to be put upon inquiry would be if the percentage of gross profit were very high.

Mr. Holman Gregory: Don't you go through the bought ledger with the invoices?—No. You check it with the purchase day book.

You check the day book by looking at the invoices?—Yes.

You see that all the stuff you have invoices for is put into the ledger?—Yes.

If in the bought ledger there is no record of a purchase but in the sales ledger there is a record of a sale, would you not then make some inquiry?—No.

Or comment upon it?—No.

Is it your duty where a large item is entered as sold to check whether it has been purchased or is in stock?—No.

Counsel: I will take your answer, but it seems a little startling. When you find an entry in the bought ledger and nothing on the premises to meet it, don't you make inquiries?—No. If I see the entry in the bought day book that is all I want.

Then you take the word of the person against whom you are checking?—You take the certified stock sheets.

Have you got them now?—They were sent back to Bradley.

His lordship remarked that Mr. Gregory was dealing with the February balance sheet. He (the judge) wanted to point out that the mistake in the balance sheet had nothing to do with that action. It was only important if Mr. Gregory could show that in October it was Mr. Merrett's duty to find the mistake. That was another matter.

Cross-examined as to what he undertook to do, witness affirmed that it was to do no more than prepare an approximate statement. To do more would have taken two or three weeks.

You assumed that Mr. Colmer wanted to know what profit had been made during the eight months?—Yes.

Now I want to go into the details in your approximate statement of affairs. You gave cash at bank at £266. That did not represent any figure to be found in the bank book?—That may be.

Could it be arrived at by calculation of any figure?—Yes, undoubtedly.

The balance at the bankers according to the pass book was £415?—Yes. I had to make allowance for the various items in the cash book.

It is arrived at by taking the figure in the cash book?—Undoubtedly.

The writing back two cheques of £240 and £225? Do you dispute that the £225 cheque has not been properly dealt with in the accounts?—I have an explanation of that. The £225 was on the other side of the account, and I believe you will find a pencil mark rubbed out on the other side of the account. The £240 item was crossed out to the best of my knowledge, and not folioed, and the £225 was on the other side. I acted quite correctly with the £225 and the £240 according to the books.

What is the difference now?—The £225 is crossed out.

Now I want to come to the Rolls-Royce chassis, the case of Mr. Gubbay. In this account there is a debit against him and a credit to the company of £985.—That is so.

That is carried into the balance?—Into my schedule of debtors.

And goes to make up the £1,000 balance?—Undoubtedly.

Is it not the fact that the motor chassis was not purchased until January in the following year?—I cannot tell you.

Is there any other chassis you can point to that the item refers to?—No, I haven't been through the books in detail like that.

His lordship: You may have a perfectly good reason for not detecting it, but that it was a mistake seems manifest?—I believe from what Mr. Sier said that it was a mistake.

I want to ask you about an item of £56. Is it correct there was a mistake about that?—Yes.

Do you agree that the invoices were entered in the ledger, that you omitted to enter them as liabilities, although the invoices were entered in the ledger as before 31st October?—I did. The only way I can explain it is that I was working on it under pressure and late at night. I undoubtedly cast up the first column, but for some reason did not add the top figure.

Take the case of Mr. Skidmore. There are three items amounting to £119. Do you admit there is a mistake?—There was.

Was the liability up to 31st October wrongly reduced by that amount, which was paid in November?—That is so.

It appears in the books as paid in November?—It does now, but I say those dates were put in subsequently. There are a number of cases in which November has been left out altogether.

Take another amount, £68 18s. 6d. Has there been a mistake with regard to that?—There has. There again the figure has been put in subsequently.

At this stage the book was handed to the jury for them to judge.

In re-examination, witness said that in regard to the Rolls-Royce he brought in Mr. Gubbay as owing the company £795. That was the true balance according to the books at the time. There was nothing to identify any particular sale to the company or any particular dealing by the company with Rolls-Royce Ltd. in respect of this chassis.

That concluded the evidence.

In summing up, his lordship remarked that it was a very unfortunate case from several points of view. **Negligence, continued the judge, meant in law breach of duty which one person owed to another who paid him to render certain services by not bringing to bear that reasonable skill and care which a professional man impliedly undertook that he would use.** With regard to the February balance sheet, however careless the defendants might have been, they owed no duty to anyone but F. Bradley Ltd. The burden was upon the plaintiff to prove that the work the defendants did in the preparation of the October balance sheet was negligent. Mr. Merrett did not suggest that he undertook a full audit, while the plaintiff said in substance that he did. One of the first questions for the jury, therefore, was what was the real duty Mr. Merrett undertook. There was, of course, no charge of fraud against him. The report furnished by Mr. Merrett was of the greatest importance in the case, and, it seemed to him, actually set out what was undertaken to be done. That was never demurred to. Mr. Colmer's solicitor did not write back and say that was not what Mr. Merrett agreed to do. Mr. Merrett said he had taken the figures as supplied by Bradley, and that again was not objected to either by the plaintiff or his solicitor. Mr. Colmer, also, must have known from the report of the shortness of time in which the statement was prepared. It was begun on Saturday and finished on Tuesday, and as to that Mr. Merrett had stated that a full audit would have taken three weeks. This question of time seemed very important, and if the auditor was employed to check Bradley and to make a full audit, then two or three days did not seem a long time to do it in. But if the jury were of opinion that the defendant undertook to act as a check upon Bradley and advise the plaintiff what the position of the company was as an auditor did when he made a full audit, then they might properly think that the duty had not been fulfilled and there had been a breach of it. It was very unfortunate that a gentleman who was going to invest a considerable sum in a business should have been content with having the result of two or three days' work from an auditor authorised to accept from Bradley his own view of what the stock was worth, instead of having the thing done with full care. The result was that he had lost between £1,900 and £2,000.

VERDICT

The jury returned a verdict for the plaintiff and assessed the damages at £250. Judgment was entered accordingly. A stay of execution was granted with a view to possible appeal.

THE AMMONIA SODA COMPANY LTD. v.
ARTHUR CHAMBERLAIN AND OTHERS*

(Decided by Mr. Justice PETERSON, in the Chancery Division on 10th July, 1917)

Held, that a company may write up its assets as the result of a bona fide revaluation, and may divide current profits without first making good prior losses.

Held further (a) There is no rule of law which forbids a company from setting off an appreciation in the value of its capital assets, as ascertained by a bona fide valuation against losses on revenue account, and (b) the dividends in this case were not in fact paid out of capital but out of current profits.

* [1918] 1 Ch. 266; 33 T.L.R. 509; *The Accountant* L.R., Vol. LVII, p. 14.

This action was brought by the plaintiff company against Mr. Arthur Chamberlain and Mr. Allan Thomas Cocking, former directors of the company, and others, asking that the defendants might be declared liable to refund to the company sums amounting to £1,268 14s. 4d., applied from 1912 to 1915 in paying dividends on the share capital.

The company was incorporated in July, 1908, as a private company limited by shares. Its primary purpose was to acquire the business and assets of a private partnership formed by the late Iwan Levinstein and the defendants, Chamberlain and Cocking, and others, trading as 'The Ammonia Soda Co.', including the freehold property near Plumbley, Cheshire, known as 'The Holford Hall Estate', with the chemical works then erected or in course of erection. The partnership was designed to carry on there or elsewhere the manufacture of ammonia soda and other allied chemicals. By special resolution passed on 31st October, 1911, the company was converted into a public company, and its capital was increased by the creation of 150,000 six per cent. cumulative preference shares of £1 each. The whole of the preference shares were offered for public subscription in May, 1912, on the terms of the prospectus, and 80,971 were applied for and allotted.

The price paid by the private company for the Holford Hall Estate was £51,086, of which £5,000 was paid in cash and the balance of £46,086 was satisfied by assuming liability for a mortgage debt of that amount charged on the estate. Between the incorporation of the company and 31st July, 1911, the company debited the land account with sums amounting to £12,160 6s. 5d., including interest on the mortgage and the cost of registering the company. In January, 1910, the company issued shares to the amount of £1,500 and entered in its books as an asset the goodwill of its business at the value of £1,500, and this item appeared on the assets side of its balance sheet for 12th January, 1910, and 31st December, 1910. Between its incorporation and the end of 1910 the carrying on of the company's undertaking resulted in a total net loss of £19,028 5s. 4d. In the first seven months of 1911 the business of the company yielded a net profit of £6,057 7s. 1d., which reduced the total standing in the company's books to the debit of profit and loss to £12,970 18s. 3d.

At a meeting of the company's board of directors, on 12th July, 1911, it was resolved that the company should be turned into a public company. It was also resolved: 'That, having regard to the various boreholes that have now been made, and the amount of knowledge that has been acquired of the brine and salt land, it is desirable to make a revaluation of the land in accordance with our present information, and that the chairman' (the late Mr. Arthur Chamberlain, senr.) 'and Mr. Cocking be accordingly requested to report to the next meeting of the board what sum would, in their opinion, represent the value in accordance with our present knowledge.'

At a meeting of the board, held on 23rd August, 1911, the chairman and Mr. Cocking presented a report and valuation, advising that the company's land should be valued at £79,166, with the addition of the expenses incurred by the company in sinking shafts and other items already expended upon the land and charged against it in the company's books. In the balance sheet for 31st July, 1911, £20,542 2s. 8d. was added to the value of the land, and this sum was credited to a reserve account and used to cancel: (1) The outstanding debit of £12,970 18s. 3d.; (2) goodwill amounting to £1,500; and (3) cash bonus amounting to £1,980 on the acceptance of shares in satisfaction of debenture bonds, leaving a balance of £4,091 4s. 5d. to the credit of the reserve account.

In the half-year ended 31st January, 1912, the company's undertaking yielded a net profit of £7,348 13s., and in the balance sheet the increase in the value of the company's lands was £16,450 18s. 3d., thus eliminating the credit balance of £4,091 4s. 5d. From September, 1912, to April, 1915, dividends amounting to £1,268 14s. 4d. were paid on the preference shares. Practically the whole of the issued preference and ordinary shares of the plaintiff company were acquired by Brunner, Mond & Co. Ltd. in 1916, and the defendants alleged that they acquired their ordinary shares with full knowledge of the matters complained of, and subsequently acquired their preference shares after a full knowledge of all such matters.

Sir John Simon, K.C., Mr. Gore-Browne, K.C., and Mr. Stamp, for the plaintiff company, argued that the revaluation was not a genuine one. It was done with

an indirect and improper motive, and it was done by men who knew that they had not the necessary knowledge to do it, on a basis on which no reasonable business man could possibly act. That being so, the amount standing to the debit of profit and loss should have been wiped out before dividends were paid, and as that had not been done the amounts paid as dividends were paid out of capital, and the directors of the company were liable to replace the assets so misapplied.

Mr. Clauson, K.C., and Mr. D. D. Robertson, for the defendants, argued that the plaintiffs must prove that what was done was *ultra vires* the company, and that the dividends were, in fact, paid out of capital. Assuming that the directors were wrong in their revaluation, if the Court saw that they had acted fairly and reasonably it would be slow to make them liable.

JUDGMENT

Mr. Justice PETERSON delivered the following written judgment: In this action the Ammonia Soda Co. Ltd. claims that the defendants, Mr. Arthur Chamberlain and Mr. Cocking, ought to make good the sum of £8,203 18s. 4d., the amount of the dividends paid on 30th September, 1912, 31st March, 1913, 30th September, 1913, and 4th April, 1914, and the sum of £4,284 12s., part of the dividend of £4,912 10s. 1d. paid on 31st March, 1915 (a total of £12,468 10s. 4d.), or so much thereof respectively as was paid out of capital. The claim was by counsel based on two grounds: (1) That the payments were made out of capital; and (2) that they were not made out of available profits. Mr. Chamberlain and Mr. Cocking were two of the directors of the plaintiff company at all material times; but the leading spirits among the directors appear to have been the late Mr. Arthur Chamberlain (the father of the defendant, Arthur Chamberlain) and a Mr. Levinstein, both of whom are now dead.

In the year 1907 Mr. Levinstein had an option to purchase from Mr. John Henry Davies the Holford Hall Estate at Plumbley in the County of Cheshire, which consisted of about 260 acres. This option provided that Mr. Davies was to sink a shaft for the purpose of proving whether there was a natural supply of brine, and make a road at his own cost. Mr. Davies sank a shaft and reached a brine run which appeared to be inexhaustible.

Mr. Levinstein then approached Mr. Arthur Chamberlain, senior, with the object of asking him to participate in the adventure, and on 2nd September, 1907, the property was conveyed to Mr. Levinstein, Mr. Arthur Chamberlain, senior, the two defendants, and some others, all of whom were described as trading as the Ammonia Soda Co., for £51,086, of which £5,000 was payable in cash, while the balance, £48,086, was left on mortgage. One of the terms of the contract, which was made with Mr. Levinstein and Mr. Arthur Chamberlain, senior, was that those gentlemen should give Mr. Davies the option of finding one-third of the capital of any company which might be formed for the purpose of developing the land, which was described as 'brine land', or, in default, should pay him the further sum of £5,000. The purchase price may therefore be taken as £56,086. Some buildings appear to have been erected by the firm before the formation of the plaintiff company, but, having regard to the shortness of the period between the conveyance to the firm and the formation of the company, it is probable that the necessary buildings had not progressed very far, the consideration being expressed to be £55,000 in shares, and the liability for the mortgage of £46,086, making a total of £101,086, of which £15,281 was attributed to property passing on delivery, thus leaving the sum of £85,805 for land, buildings and fixtures.

On 20th July, 1908, the plaintiff company was incorporated as a private company with a capital of 10,000 shares of £10 each, subsequently increased to 15,000 of £10 each, or £150,000, and the property was conveyed to the company.

For a company carrying on this kind of business it is of the utmost importance to secure a supply of brine. Over the salt deposits in Cheshire pass what are called 'brine runs', i.e. more or less defined streams of underground water which flow over the surface of the salt deposits and become saturated with salt. The demand for rock salt is very limited; but a constant supply of brine is very valuable for manufacturing purposes. It is possible to obtain brine by pumping water from the surface on to the deposits of salt, but a natural brine supply has two advantages: (1) It is cheaper to work; and (2) owing to the fact that it comes to the bore-

hole already saturated there is very little, if any, danger of the surface being let down. A large deposit of rock salt, therefore, is chiefly of value as a source from which brine can be obtained by the application of water from the surface in the event of the natural brine supply being exhausted, either because it is limited in quantity or because it is intercepted by the operations of other works; but this method of providing brine is open to the objection that, if large quantities of salt are recovered in this way, the surface may subside, the subsidence varying from serious to inappreciable, according to the depth from which the salt has been taken, and the resistance offered by the superincumbent strata. But it is plain on the evidence that no person who is experienced in the business of salt works would have recourse to this method while he had an adequate supply of natural brine.

The company proceeded to erect works with the object of developing the land as a brine field and utilising the brine for manufacturing purposes. For some time the company was naturally not in a position to show profits. It was engaged in erecting its buildings and sinking another bore-hole and a shaft adjoining it, but in the meantime it had various expenses which it had to meet. Some of these expenses were added to the value of the land, and some comment has been made on this, although the plaintiff's case does not appear to depend on this fact. Interest on the mortgage to Mr. Davies, income-tax, part of the cost of forming the company, a sum of £315 paid for obtaining an extension of the mortgage, and a sum of £5,000 paid to Mr. Davies in consequence of the failure to allot shares to him in the company were added to the value of the land in this way. Whether the £5,000 was properly paid out of the costs of the company is not a question for determination in this action; but it does not seem unreasonable, if it were paid, to add it to the land account, as it was, in fact, part of the consideration for which Mr. Davies agreed to sell. It may be that the other items, during construction, ought to have been placed to a separate account, in order that they might be cancelled out of profits during a term of years; but it does not seem to me to be very material in the present case whether they were carried to the land account or whether they were placed to other accounts. At any rate, the creditors of the company do not appear to have raised any question about this method of treating these items. The company also issued 150 shares of £10 each as a bonus or commission for taking up 300 shares, and some comment was made on the fact that goodwill then appeared in the balance sheet as of the value of £1,500. It was said that it was a novelty to describe a sum paid for taking up shares as goodwill, and some sarcasm was directed to the coincidence by which the value of the goodwill appeared as £1,500. This criticism does not, however, seem to me to have any real foundation. I have no doubt on the evidence that there was a goodwill which was at least of the value of £1,500; and if for balancing purposes it was entered at less than the real value, it does not appear to me to be a transaction to which exception can be taken.

In the early part of 1911 the company began to make profits, and it was clear that the undertaking had reached the stage when it was reasonable to suggest that it would prove a profitable concern. In April, 1911, Mr. Arthur Chamberlain, senior, suggested to Mr. Levinstein that the company should be converted into a public company, and, on 20th April, he wrote that nothing could be done until the company had more money, and added that the company owed the bank £10,000; there was the mortgage for £46,000, debentures for £18,000, and no possibility of issuing any more; that the company needed £150,000, and that the difficulty was that the accounts showed a heavy loss for the last two years. A letter of 10th May shows that Mr. Arthur Chamberlain, senior, contemplated raising the additional money required by the company by means of preference shares. The balance sheet for 31st December showed a loss of £19,028 up to that date, but of this sum £10,601 represented depreciation at the rate of 2½ per cent. on buildings and 7½ per cent. on machinery and plant. This depreciation fund was increased to £13,702 by 31st July, 1911, and to £16,293 by 31st January, 1912. In these circumstances it was desirable, before inviting applications for preference shares, to be able to produce a balance sheet which did not on the face of it show a loss of this description. It seems to have occurred to Mr. Chamberlain, senior, that the difficulty might be surmounted if the land, which by virtue of the additions to which I have referred then stood in the books at £62,605, was of sufficient value to cancel the debit to profit and loss. Mr. Chamberlain, as appears from a letter

on 31st May, 1911, suggested to Mr. Cocking that they should be appointed a committee for the purpose of making a fresh valuation of the land, and requested Mr. Cocking to bring all letters and papers either from the geologist or from the well-sinker, adding, 'That will give us any information about the amount of salt'. At a board meeting, held on 12th July, 1911, at which Mr. Arthur Chamberlain, the two defendants, and other directors were present, it was resolved that, having regard to the various bore-holes that had been made and the amount of knowledge that had been acquired of the brine and salt land, it was desirable to make a revaluation of the land in accordance with the information which the company then possessed, and that Mr. Arthur Chamberlain, senior, and the defendant, Mr. Cocking, be requested to report to the next board meeting what sum would in their opinion represent the value of the land in accordance with the knowledge which the company then possessed; and that, in view of the alteration of the company from a private to a public company, the accounts of the private company be made up to 31st July, so that the public company should start its year on 1st August, 1911, with the accounts as received from the private company on the last day of July. In speaking of the additional knowledge which had been acquired the minutes, I think, referred to the following facts, although the directors probably also had in their minds other facts which might influence the value of the land, and to which I will refer later on.

In December, 1907, the firm had made another bore-hole which, in June, 1908, was abandoned in consequence of an accident. But they had, in the opinion of Professor Kendall, shown that they possessed another brine run. They had also increased the depth of one of the bores which Mr. Davies had made from 483 feet to 1,710 feet. The company had also made a bore with the object of seeing at what depth water would be reached, in order that, if necessary, the effluent from the salt works might be disposed of by sending it down to the water-bearing strata. The bore was of great depth. It was stopped before it reached water, but it proved a bed of salt of over 600 feet in thickness. This was a quite unexpected discovery, unexpected both by commercial men and by geologists. Other bore-holes had been sunk to a greater depth in Cheshire without meeting salt of more than the usual thickness, and it may be that this is a deposit of special thickness which is peculiar to this portion of the county. Be this as it may, the discovery seems to have convinced the directors that the company had a property which was unique in its possibilities.

Professor Kendall, an eminent geologist, who specialises in the Cheshire salt fields, advised the directors, in a report which was published in the prospectus which was issued later, that the gross amount of rock salt under the company's land exceeded 150 millions of tons, that the brine used at the company's works was not the product of solution of rock salt under the company's lands, but that it flowed into the company's land as ready-made brine in a subterranean stream of exceptional magnitude, and that there were two distinct and independent runs of brine. He also advised that the brine run could confidently be expected to give a constant yield equalling all the needs, present or future, of the company, and that if the brine runs should ever fail the enormous and unprecedented thickness of rock salt would constitute an inexhaustible reserve.

None of the directors were experts in salt, their acquaintance with the business having been acquired in the course of working this property, and they seem to have thought that the discovery of this immense deposit of salt added largely to the value of the property, although on the evidence it seems to have been of geological rather than of commercial interest. This conclusion is supported by Mr. Chamberlain's letter of 31st May, 1911, from which it appears that he at least attached great importance to the amount of salt which had been found. Mr. Chamberlain, senior, and Mr. Cocking arranged that Mr. Cocking should draft a report on the value of the land. Mr. Cocking was then a director of Kynochs Ltd. but he had previously been connected with coal mines, and had had considerable experience in valuing coal. He had had no experience in valuing salt or brine lands, and the valuation, which was the result of his labours, seems to indicate that he did not realise that salt and brine lands required to be valued on a basis other than that which would be applicable to coal measures with which he was familiar. His pocket-book showing the method by which he arrived at his con-

clusions has been produced. From this it appears that, after stating that the minimum depth of the salt proved was 175 feet, and the maximum was 666 feet, he came to the conclusion that, taking the maximum depth, there were 76 million tons of salt under the company's property, and that, at one penny per ton, would represent £316,666; he realised, however, that the whole of this salt could not be taken, and, accordingly, he assumed that one-quarter of it could be won, and thus he arrived at £79,166 as the value of the land, or £494 per acre.

In a letter of 17th August, 1916, Mr. Chamberlain, senior, requested Mr. Cocking to bring a draft report on the present value of the company's brine land to the next board meeting. This board meeting was held on 23rd August, 1911, and the only directors present were Mr. Chamberlain, senior, and Mr. Cocking. These two gentlemen presented their report and valuation. That report and balance sheet is in these terms: 'The basis on which we have ascertained the salt value of the company's estate is as follows: Three brine shafts or bore-holes have been sunk. Two were sunk by the parties selling the land for the purpose of proving the salt. The first of these, after enlarging, was used for our present brine shaft, obtaining what, so far as our demand has been able to prove it, has been an inexhaustible supply. In addition, we had test trials for several weeks at this bore-hole, withdrawing 6,000 gallons per hour, without in the slightest degree lowering the level of the brine or reducing its strength. The second, which was left at a depth of 483 feet, we extended to a depth of 1,710 feet. The third was a bore-hole that we undertook with the object of discovering, if possible, at what depth in the strata water would be found. This boring was carried to a depth of 2,509 feet. We found no water, but we proved the enormous quantity of 666 feet of solid rock salt. In No. 2 we first proved 175 feet of solid rock salt, and after an interval of 190 feet a further thickness of 251 feet. In general terms there is no reason to doubt that this condition extends all over, only varying in thickness of the rock salt, there being reason to believe that deposits are increasing towards the north-west and decreasing towards the south-east. For the purpose of our calculation we have taken the upper bed of 175 feet only, and made no estimate of the other deposits. Assuming that the upper bed deposit of 175 feet extends over the whole acreage, and not assuming anything for the lower and more extensive beds, there would be 76,000,000 tons of salt available for use. This salt might be safely valued at 6d. per ton, but for the purpose of our calculation we have assumed the value to be 1d. per ton, and, further, we have assumed the quantity to be extracted as being one-quarter of the amount above set forth. In that way we get—quarter of 76,000,000 tons at a 1d. per ton, £79,166, and we advise that the land be valued at this amount, taking no account of its surface value but adding to this the expense incurred in sinking shafts, and other items already expended on it and charged against it in our books. Thereupon it was resolved that the report be received, approved, and entered on the minutes.'

Obvious comments on this report and on the methods of arriving at this valuation appear to those who have been instructed in its fallacies by men who are experts in the salt business. In the first place it values the salt as salt although it refers to an existing 'inexhaustible brine supply' which was of far greater importance. Its authors seem to have contemplated that the salt would be won like coal, but the evidence is abundant that the market for rock salt is very limited. It is curious also that the calculation should have been based on the minimum thickness of 175 feet when it was the discovery of the lower deposit of salt of much greater thickness which led them to think that the company had acquired a property of unexpected value; but possibly this was due to the fact that the great deposit had only been proved at one point. It was also a matter of comment that the reports stated that the value of the rock salt might be taken at 6d. per ton while the value taken 'for the purposes of the calculation' was one penny per ton. This moderation was, I think, due to the purposes for which the calculation was made. What was decided was to wipe out the existing debit, and it was sufficient for this purpose if the valuation showed the smaller figure. Before me no serious attempt was made to justify the basis on which this valuation was made, although the defendants called evidence to prove the value of the land was approximately that at which Mr. Cocking had arrived.

Having increased the value of the land in this way, the balance sheet for 31st July was prepared in accordance with the resolution of the board on 23rd August,

which I have read. This balance sheet showed the land as of the value of £83,788, being the aggregate of £63,246 and £20,542, the additional value on revaluation by the directors. On the other side of the account this additional value appeared under the heading 'Reserve account', and from it were deducted the balance to the debit of profit and loss account (£19,028) less the profits for the seven months up to 31st July (£5,682), and income-tax recouped (£375), and also the item of £1,500 for goodwill, which had appeared in the previous balance sheet, and a premium on redemption of debentures (£1,980), leaving a balance to reserve account of £4,091. The object of the revaluation was thus achieved, the debit balances were wiped out, and the way was open for the conversion of the company into a public company and for inviting subscriptions for preference shares.

The balance sheet was signed by Mr. Chamberlain, senior, and by Mr. Cocking, and the auditors, Messrs. Thomas Johnston & Co., certified the balance sheet, adding a special note which called attention to the fact that the directors had revalued the land, increasing the value by £20,542, which had been placed to a reserve account, against which had been written off loss on trading to date £12,990, goodwill £1,500 and premium on redemption of debentures £1,980, and contained the statement that, 'subject to the foregoing, in our opinion the balance sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs'. It is to be observed that while the auditors called attention to the revaluation and to the application of the increase, they do not appear to have advised the directors that it was improper to apply the increase in value to the writing off of the various items to which they referred. The balance sheet was presented to and approved by a board meeting held on 27th September, 1911, at which Mr. Chamberlain, senior, and the two defendants were present. In the meantime Mr. Duff, who had been put on the board as a technical director, had had serious differences with Mr. Chamberlain, senior, about the management of the works, and in a letter of 22nd September complained that he was 'reduced to a puppet on the board, to further schemes of company promoting with which he was not fully acquainted', and on 19th October he tendered his resignation stating that he never approved of the new valuation of the land and adding that the so-called valuation, which he had not seen, could not, from what he had heard, be in any way a proper and reliable one, as only an independent trained expert should have been instructed on such a piece of work. On 31st October there was a board meeting at which Mr. Chamberlain, senior, reported that he had received a letter of 29th October from Mr. Duff, tendering his resignation, and that he had accepted it, but the minutes do not show, and the evidence did not establish, that Mr. Duff's hostile observations on the revaluation, which he stated he had not seen, were communicated to the board. On the same 31st October an extraordinary general meeting of the company was held, when seven members were present, including Mr. Arthur Chamberlain, senior, and the two defendants. At this meeting it was resolved that the company should be converted into a public company, that the capital should be increased by the creation of 150,000 preference shares of £1 each, and that the accounts for the seven months ended 31st July, 1911, and the directors' and auditors' reports thereon be received and approved of, and that the revaluation of the salt land therein referred to should likewise be approved. The company, therefore, in general meeting sanctioned and approved of the valuation which had been made by Mr. Cocking and Mr. Chamberlain, senior. In March, 1912, a balance sheet and a profit and loss account were prepared, as of 31st January, 1912. The balance sheet showed an additional value upon revaluation by the directors £16,450, this figure being the result of deducting from the original £20,542 the balance of £4,091 remaining at reserve in the balance sheet of 31st July, 1911, while the profit and loss account showed a balance of profits for the year of £7,348, after deducting the sum of £5,682, which had been passed to reserve in the balance sheet of 31st July, 1911. A prospectus was then issued in May, 1912, inviting applications for the preference shares, and resulted in the allotment of a considerable number of shares. On these preference shares dividends were paid amounting in the aggregate to £13,116. Neither of the defendants held any of these preference shares.

In the early portion of 1916, Brunner, Mond & Co. Ltd. purchased the bulk of the ordinary shares and a large portion of the preference shares at par, and

appointed their nominees as directors, and in due course the new board instituted this action.

It will be convenient if at this stage I state the conclusion at which I have arrived with respect to the revaluation. In my judgment the directors were not guilty of any *mala fides* in the matter. Mr. Chamberlain, senior, was obviously the master spirit in the company, and admittedly he was a man who had a high reputation for integrity and capacity. It was said that the object of this revaluation was to enable the company to obtain further capital by the issue of preference shares. I think that this was so; but there is nothing unlawful or reprehensible in that object. The only ground on which complaint could be made is that the object was achieved by improper means. The directors, no doubt, would have been better advised if they had obtained a revaluation from some expert valuer, although, if one may judge by the evidence on the subject which I have heard, the margin of difference between the views of values on the subject is very great. **But there is no rule of law which requires directors to obtain outside assistance in such matters or prevents them from valuing the property themselves, provided, of course, that they act honestly in doing so.** In this case the directors requested two of their number to revalue the land and, unfortunately, the two who were selected were not really competent to deal with the problem. As I view the evidence the directors, not being adequately conversant with the salt business, entertained inflated ideas of the value of the large deposit of rock salt which had been discovered, and the members of the company who attended the extraordinary general meeting on 31st October, 1911, all of whom seem to have been business men, appear to have held the same mistaken belief. In my judgment the valuation, whatever may be its demerits, was honestly made, and I exonerate the directors from any charge of *mala fides* in connection with it. While this method of revaluation is clearly open to animadversion, and, indeed, no serious attempt was made to justify the basis on which it was constructed, it still may be that the result is approximately correct, and I have, therefore, to consider whether the land in August, 1911, was approximately of the value of £83,788. The evidence which was adduced on this point was more than usually divergent. On the one hand the plaintiffs called two witnesses, Mr. Showall and Major Jackson. Mr. Showall is an incorporated accountant who is one of the officials of the Salt Union. He is not a valuer and, as he said, it is not his business to value. Major Jackson is a land agent who had had considerable experience in the management of salt estates. His view was that far too much was given for the property. Mr. Davies said that at the present time its value is £210 per acre, or £32,000. Taking the purchase price as £51,086, plus the £5,000 subsequently paid to Mr. Davies, or £56,086, Major Jackson was of opinion that, in 1907, the price paid was at least £24,086 in excess of the true value. His valuation was, however, on the basis of a vacant site. He admitted that if the land were fully equipped with manufacturing works that fact would make a difference, but as he was not in the habit of valuing land in those conditions, he was not prepared to offer an opinion what would be the extent of the difference. I cannot accept Major Jackson's view of the value of this land.

Whatever was the true value of this land in 1911 I do not on the evidence before me think that Major Jackson's estimate can be treated as approaching the real value. The defendants on their side called three experts or witnesses, Mr. Stocks, Mr. Gandy and Mr. Newton. They agreed that salt lands with a proved brine flow were extremely difficult to acquire, and they concurred in the view that £80,000 was a reasonable sum to fix as the value of these lands in 1911. It may be that their estimate is in excess of what could be realised on a sale, but on the whole I think that they are probably much nearer the value than Major Jackson was in the estimate which he made. There are several facts which should be borne in mind. The land might fairly be valued as part of a going concern which has every prospect of earning large profits. It has been found that it possessed two independent and inexhaustible salt runs, and that the brine reached the plaintiffs land in a saturated condition. The plaintiff company had acquired a right of discharging its effluent into the brine for a period of twenty-five years, and while it is true that the pipe-line where it crossed the railway might be removed on short notice, it seems fairly clear that it was in the interest of the railway company not to determine the right in the case of a company which used

the railway for the purpose of conveying its products. Moreover, the great deposit of salt had, I think, some value, the figure being put by one of the witnesses at £3,500. The price paid for the land to Mr. Davies was £5,000 in cash and £46,986 secured by mortgage. Some additions, particulars of which were not supplied to me, were made to the £5,000 in 1908, making that sum £7,421. Various additions up to 31st July, 1911, were made for an option in respect of other land, and the price paid for this extra land, expenses in connection with the pipe-line and redemption of land tax, and these additions were not objected to. In addition, the company paid the further sum of £5,000, which was payable to Davies on the failure of the purchasers to procure the allotment of shares to him.

If these items are added together they amount to £59,432, or roughly £60,000. It is true that Major Jackson thought that the price originally given was excessive, but that price was at any rate secured by Mr. Davies, and in this region of varying opinions and estimates it is a fact of some solidity. If regard is had to the considerations which ought, as I have said, to be borne in mind, a witness might well come to the conclusion that the value of the land as part of a going concern was considerably in excess of the £60,000. Whether the value was as much as £80,000 may be open to doubt. It is not, I think, improper in this connection to remember that the directors of Brunner, Mond & Co., who do not, I suppose, yield to anyone in their capacity of judging of the value of salt lands, thought that their company would be well advised to buy as many of the shares of the plaintiff company as could be obtained, preference and ordinary, at par, and that it was only after the shares were acquired that their neighbours on the board of the plaintiff company were shocked at the value at which the lands stood in the balance sheets. No doubt one of the motives, it may be the principal motive, in acquiring these shares and obtaining control of the plaintiff company was to get rid of the competition of a trade rival, but I see no reason for supposing that there was any idea that the value of the land as it appeared in the balance sheet was, as is now suggested, between £40,000 and £50,000 in excess of its real value.

I do not propose to attempt to say what in July, 1911, was the real value of the land as part of a successful undertaking. On the evidence before me I think that it was less than £80,000 and considerably in excess of £60,000. Nor do I think that it is necessary for me to arrive at a more definite or precise conclusion. The directors of the plaintiff company in my view honestly entertained the view that the land in 1911 had largely increased in value, and the plaintiff company in general meeting adopted their views, knowing that the valuation had been made by the directors, and knowing, as they must have known, that the directors who had made the valuation were not professional valuers or men who had had a long experience in the salt business.

There is not any ground for suggesting that any facts were concealed from the shareholders by the directors. In these circumstances it is not, in my opinion, open to the company to attack the directors for an honest, though it may be erroneous, estimate which has been expressly adopted by the company in general meeting after the attention of its shareholders had been pointedly called to the resolution by the auditors' certificate which was attached to the balance sheet.

It was contended, however, that there was no justification for the payment of the dividends in question, even if the valuation was honest and even if in its result it was correct. Mr. Gore-Browne said that the essential question was whether or not capital assets could be written up so as to justify payment of a dividend, that the valuation, however careful and however thorough and satisfactory to the Court, was not a justification for paying dividends, that the profit and loss account was a continuous account which was always open, and that there was no profit on it until all past losses had been worked off. My attention was directed to a long series of cases which dealt with the method in which a company's accounts ought or ought not to be kept, but it is not altogether easy to reconcile them. I have before me, however, the warning of Lord Halsbury and Lord Macnaghten in *Dovey v. Cory* (17 *The Times* L.R. 732; [1901] A.C. 477) and I propose to lay to heart, as far as possible, the example of Lord Macnaghten when he declined to formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs.

paid-up capital was not intact. It is also to be observed that, in *Lee v. Neuchatel Asphalte Co.* (*supra*) the decision both of the Court of Appeal and of the Court of first instance proceeded upon a finding that the value of the assets, ascertained by valuation, was greater than it was when the company commenced its business. This was a case in which the question was whether dividends could be paid and the Courts which dealt with it did not see any impropriety in ascertaining whether the capital assets had, in fact, been increased or diminished in value. **Directors would, no doubt, not be justified in ascribing to a fixed asset a value which is the result of purely temporary fluctuations. It is one thing to treat an unrealised increase in value of a fixed asset as profit and to pay dividends out of it as profits; but it appears to me to be a different question whether in considering whether there is a deficiency in paid-up capital, owing to past losses, which ought to be made good out of future profits, the real value of the assets can be ascertained with the object of discovering if, in fact, there is a deficiency in the paid-up capital.**

As Lord Justice Lindley said in *Lee v. Neuchatel Asphalte Co.* (*supra*), 'You must not have fictitious accounts. If your earnings are less than your current expenses, you must not cast your accounts so as to make it appear that you are earning a profit, and you must not lay your hand on your capital to pay dividends.' In saying this, the learned judge plainly meant that you must not pay a dividend out of your paid-up capital.

In *Bond v. Barrow Hæmatite Steel Co.* (*supra*) Mr. Justice Farwell summarised the result of the authorities in this way: 'There is no hard and fast rule by which the Court can determine what is capital and what is profit'. The mode and manner in which a business is carried on and what is usual or the reverse may have a considerable influence in determining the question—per Lord Halsbury in *Dovey v. Cory* (*supra*). It may be safely said that what losses can be charged to capital and what to income is a matter for business men to determine, and it is often a matter in which the opinion of honest and competent men will differ. *Gregory v. Patchett* (33 Beav. 595). There is no hard and fast legal rule on the subject—per Lord Justice Lindley, M.R., in *In re National Bank of Wales* (*supra*). A similar view was expressed by Mr. Justice Warrington in *Hinds v. Buenos Aires Grand National Tramway Co. Ltd.* (23 *The Times* L.R. 6; [1906] 2 Ch. 654). In the present case, the business men who were the directors and shareholders of the plaintiff company, of whom some, at least, were very competent, were of opinion that it was, in the circumstances, quite proper to apply the increase in the value of the fixed assets, in cancelling the previous deficiency of capital assets, and that, as the company's assets were equal to the liabilities and paid-up capital, there was no adequate ground for contending that the balance to the credit of profit and loss account ought to be applied in making up paid-up capital which had been lost.

Even if the increase in the value of the fixed assets ought not to have been applied in this way, I should not be inclined to hold the directors liable for the dividends which were paid. The problem is not by any means a simple one. I am satisfied that the directors acted honestly. What they proposed to do was clearly shown in the balance sheet and the auditors' report, which were submitted to the general meeting of the company in October, 1911. Most, if not all, of the shareholders who attended that meeting were commercial men, and they unanimously approved of the proposal. The auditors, while they properly called attention to the revaluation by the directors and to the way in which it was proposed to apply the increase in the value of the land, do not appear to have advised the directors or the shareholders that there was any impropriety in dealing with the increase in this way; and the same firm of auditors and an additional firm of auditors, both of whom were admittedly experienced Chartered Accountants, certified the balance sheet of 31st January, 1912, without suggesting any doubts as to the correctness of the course which had been pursued. 'Directors are not liable for all the mistakes which they may make, although if they had taken more care, they might have avoided them. Their negligence must be, not the omission to take all possible care; it must be much more blameable than that; it must be in a business sense culpable or gross'—per Lord Justice Lindley, M.R., in *In re National Bank of Wales* (*supra*). In a case where there is no question of an *ultra vires* act, it would be difficult for the company to make directors liable

for following a course which had been approved by the shareholders, with full knowledge of the facts, in general meeting.

In my judgment, then, the present action fails and must be dismissed with the usual consequences.

THE CALNE GAS CO. v. CURTIS*

(Decided by Mr. Justice SALTER, in the King's Bench Division, on 31st July, 1918)

This case dealt with the liability of a company auditor for damages caused by his failure to detect the frauds of a former secretary of the company

This was a case in which the Calne Gas Co. sought to recover damages from Mr. George J. Barron Curtis, incorporated accountant, Bath, the company's auditor, for alleged negligence in the performance of his work as auditor.

Mr. Schiller, K.C., who appeared for the company, said the action arose out of the defalcations of a former secretary to the company, who embezzled £700 of the company's moneys, and it was alleged that the defendant, as auditor, did not exercise reasonable care and skill. The defendant, although he had been auditor for twenty years, made the assertion that it was not his duty to check slot meter payments with the cash book and to see that the amounts were paid into the bank. It was not necessary for such a small company, whose gross revenue was just over £4,000, to keep a large amount of cash in hand. Probably £30 was quite sufficient, but during several years it was £300 or £400 in the first three quarters and substantially decreased at the end of the year. These amounts should have arrested the attention of the auditor, and if he had made inquiries the whole of the secretary's defalcations would have been discovered. The balance was reduced at the end of each year in order to deceive the auditor, but a skilful and careful accountant ought to have seen through it. With regard to the receipts from slot meters, the entries in the books were very irregular and should have attracted the attention of the auditor. When the secretary joined the army in February, 1917, the directors found that the books had been very badly kept for years, and they wrote to the defendant complaining that he had not discovered the fact. The defendant replied that he was the company's auditor, not their accountant, and that his duty was to check the accounts after they had been prepared by the secretary, adding that the auditor was not to be blamed for a state of affairs caused by the directors placing more work on the secretary than he was able to do.

Mr. H. S. Ward, chartered accountant, who had investigated the company's books, stated in evidence that the slot meter books showed for the December, 1909, quarter a debit for gas consumed of £128 11s., while the credit appearing against it was only £47, and said that alone should have put the defendant upon inquiry. The difference was so pronounced that it should have been noticed. It was impossible for a gas company like this to have such a large sum lying about in gas meters. In the course of cross-examination,

Mr. Justice Salter remarked: The point that the witness makes on this cash book, in 1915, is that it shows a sum of £250 and an increasing sum, apparently accumulating in the hands of the secretary and not paid into bank. I suppose if the money had been promptly paid in there would have been no such difference. That is the point.

Mr. Foote, K.C. (for the defendant): I understand that the cash book is not balanced until the end of the year?

Witness: That is another point I make. That was a bad practice.

Mr. Justice Salter said the defaulting secretary had a larger amount in hand in September than at the end of the year. He understood what this man did was that in the last quarter of each year he paid into the bank large sums of money as large as the books showed, but that that money was money recently received from customers paying their accounts. And he did not then enter in the books those amounts paid, but carried them on to the next year. Were there no paying-in counterfoils?

Witness: There were some counterfoils, but certain of them were not properly made out.

Mr. Justice Salter: The shrinkage of the cash balance at the end of the year

* Reported by *The Gas World*; *The Accountant* L.R., Vol. LIX, p. 17.

was suspicious. Then comes the question as to whether the auditor ought to have detected that.

Mr. Parr (for the company) to witness: What was there in the last quarter which ought to have attracted the attention of the auditor?—The absence of any collections in the last quarter with the presence of large prepayments in the first three quarters and that no one had apparently been round to the prepayment meters for six weeks.

Mr. Parr then referred to the account of Messrs. J. H. & A. Cole, bone manure merchants, of Bristol, from whom a cheque had been received for £53, 10s. 1d., but which was entered in the cash book as £3 10s. 1d., and the £50 carried forward as arrears in the ledger.

Witness agreed that that was so.

Mr. Justice Salter: I suppose the point is that a substantial firm like that should only pay £3 odd on account of £53?

Mr. Parr: That is so.

Counsel then drew attention to several erasures that had been made in the books, and witness said that erasures, in his opinion, should always excite suspicion.

Mr. Foote observed that his case was that certain figures had been altered from the original figures after the defendant had audited the books.

You would expect the same degree of skill from a man receiving five guineas a year as you have bestowed in this matter?

Witness: The fee has nothing whatever to do with the auditor's duty.

You think not?—I am sure not.

Supposing, instead of taking six days, it took six weeks, he would be bound to do it for five guineas?—Not at all.

Your view is that if this work took him six weeks he was bound to do it?—The amount of the fee has no bearing on the amount of work expected of him.

The directors had some duty?—But they are distinct from the auditor's duty.

Do you suggest, whether the auditor received five guineas as fee or 5,000 guineas, it was his duty to write to the customers to see whether they admitted owing the amounts charged against them?—No.

Do you suggest that it is the duty of an auditor to go through the paying-in slips?—Yes, although perhaps it is not a regular thing to do.

Assuming there was no suspicion and Mr. Curtis had been assured by the chairman of the company that they were absolutely assured as to the integrity of Archard (the former secretary to the company), do you suggest it would be his duty to ask for the paying-in slips?—No; not his duty, but as a common-sense precaution. Witness added that experience showed that the composition of items paid into bank was a very valuable test. Where a man was collector and secretary, witness would take more precaution in making his audit, and pursue his inquiries further than he otherwise would. Slot meters offered an easy avenue for fraud, as the payments were in cash, and, therefore, a certain amount of testing was absolutely necessary.

Do you suggest it is the duty of an auditor to do that with every item?—Not necessarily. In answer to further questions, witness said time was no object in an audit; the great thing was to get it right. Liability as an auditor had no relation to the fee paid. It took him about three weeks to discover the errors in the books, but that was over a period of ten years. At the very commencement the defendant, in witness's opinion, ought to have found these matters out. He understood there were three men now doing the work that Archard used to do. He did not agree that if the company had had three men doing the work at the time in question the defendant would have more quickly discovered the defalcations. Witness did not agree that the directors were at fault in allowing one man to do the work of three.

His lordship: Negligence of the directors is no defence to you, Mr. Foote.

Mr. Foote agreed, but submitted one had to look and see what the auditor had to do and the surrounding facts.

Mr. Foote: Do you not think these were very ingenious frauds?—No, I don't think so. They are the simplest I have ever seen.

Re-examined by Mr. Schiller, witness stated that an auditor must judge for himself as to the things he must do in an audit, being guided by the general rule

that he had got to satisfy himself that he had arrived at accurate results as far as possible.

Mr. Harold J. Morland, F.C.A., F.C.I.S., a partner in Price Waterhouse & Co., who was the next witness, agreed generally with Mr. Ward. The frauds followed the usual lines in matters of this sort. There was nothing fresh that one had not seen before. The first thing that would have attracted his attention was the cash book. That did not show that the money received had been paid into bank.

In cross-examination, witness said an auditor was bound to look out for fraud, although he did not expect to find it. The whole system of the gas company's book-keeping was unsatisfactory, especially the cash book, as the form in which it was kept facilitated the deception of the auditor. He did not agree that it was part of the duty of an auditor to examine the counterfoil receipt books. He had a very low opinion of counterfoil receipt books as a help in auditing. But if suspicion arose he would naturally turn to every available source, including the counterfoil receipt books. One of the difficulties in the audit of a gas company's books like those in question was that there was so much cash passing. That was why it was so necessary to be very careful. He agreed that the fee of an auditor was based very largely on the amount of time the audit was likely to take. Naturally, if the fee was insufficient for the work the auditor should approach the directors for an increase.

His lordship: What do you say to a fee of five guineas for an audit of this kind?—I have not much experience of country audits, but it strikes me as a very low fee.

Mr. Charles Bartlett, chartered accountant, Bristol, said he was the present auditor of the plaintiff company's books. He had examined the principal books for the period in question—the gas rental ledger and the cash book. In his opinion, throughout the period in question, there were many things in the books which would have put a reasonable and careful auditor upon inquiry. For one thing, the outstanding debts were very large in comparison with the amount of the company's business. The many erasures in the books should also have raised suspicion. He had to some extent altered the system of the company's book-keeping. The old arrangement under which one man acted as sole collector and sole secretary had been altered also. He received 20 guineas for the audit, and extra for making up. With regard to the amounts which had been outstanding for two years in defendant's time, he would have asked the directors for an explanation of the amounts; and, failing that, he would have applied to the shareholders.

Mr. Foote: But supposing the chairman had said he was satisfied with regard to the amounts?—I should have thought he was in league with the secretary.

Mr. Stephen Tyron, chartered accountant, said he had examined the books of the company for the period in question, and he was of opinion there were several things appearing in the books which ought to have put an auditor on inquiry.

At the close of the company's case, Mr. Foote called the defendant, Mr. Barron Curtis, who stated in evidence that he had been in business at Bath for thirty-five years. For the past eighteen years he had been one of the auditors of the Bath Gas Co., and held a number of other big appointments in the same capacity and attended to a large number of private audits. He was appointed auditor to the Calne Gas Co. in 1896. When he took up that position Mr. G. J. Gough was the secretary, and he was also town clerk of Calne. Mr. Gough was a well-known solicitor in that part of the country, with a large practice. When witness accepted the office of auditor, Archard was a clerk in the employment of Mr. Gough and was generally employed by Gough as a solicitor's clerk, and he attended to the books of the plaintiff company. For the work he did as auditor he received a fee of five guineas yearly, out of which he had to pay his own hotel and railway expenses, leaving witness for himself a sum of about £4 10s. The gas rental ledger and the cash book were usually sent to witness's office at Bath a few days before he went to Calne for the purposes of the audit. After Mr. Gough retired Archard became secretary. He was elected to that position because he had been doing the company's work in Mr. Gough's office. In 1913 witness saw more of Archard, as witness was asked to go up to Calne more frequently, as it would be the means of keeping Archard more up to his work, he was told. He at once asked Mr. Haines, the chairman of the company, whether he had any doubt about Archard, and the reply was—none whatever, the company had every confidence in him.

That confidence in Archard continued until the discovery of the frauds in 1917. Under the new arrangement witness went up every six weeks to Calne to examine the books as far as he was able, and for which he received extra remuneration. He first observed that the amount of arrears in prepayment slot meters was increasing about 1913.

What explanation did Archard give you?—That he had no time to make the collections.

Was there any reason why he should not have time?—Yes. He had a lot of trouble with the men in 1913-14, and in 1913 there was some trouble with the manager also. Archard was appointed manager in 1915. He spoke to Archard several times about the arrears in 1913, and having regard to the condition of affairs at that time he considered the explanation was reasonable.

Was the man overworked in your opinion?—Yes, and underpaid. Archard explained that the erasures in the books were items which had been entered in error under the wrong year. Witness complained to the chairman in 1914 that Archard had too much to do and that things were getting very much behind, and Mr. Haines promised to see into it. As far as witness could see, however, nothing was ever done to remedy the matter.

Continuing his evidence, the defendant said he tested the accounts with as much care as in the case of all his other audits, taking all precautions. Some of the entries appeared to have been altered after his audit. He made the interim audit in 1916, but did not complete the audit for that year. At that time the books were months behind. He was of the opinion that if there had been more assistance the defalcations would have been detected very much earlier.

Cross-examined by Mr. Schiller, K.C., witness said he inquired of the secretary how the lump-sum receipts from slot meters were made up, but he did not test them by reference to any books; he did not know that such books were kept. The secretary (Archard) said the sums were made up from collections of various meters, and the only means of checking them would be to go through the meter books. He accepted what Archard said. He had no suspicion he was telling him anything that was wrong.

If Archard had made a mistake in his figures, you had no means of finding it out?—An auditor is not responsible for the amounts collected from the slot meters.

If Archard had made mistakes in these lump-sum figures which you accepted as correct, nothing that you did in auditing would have enabled you to discover the mistakes?—No.

Is not one of the first duties of an auditor to see that there are no mistakes in the accounts?—Yes.

And in this matter you took no steps which would have made mistakes impossible?—I took all the steps I considered I possibly could to check the amounts.

You have to satisfy yourself that the items are true items?—Yes.

How could you satisfy yourself that these lump-sum items credited to prepayment slot meter accounts were true items unless you checked them with the meter books?—I could not do it, and no auditor will do it either. I do not know of any auditor that checks all these items.

Did you take any steps to satisfy yourself that these were true entries?—Only by taking them out at random, checking perhaps half a dozen or a dozen with the meter books. It is not the duty of an auditor to go through every individual item. He cannot possibly do it.

Do you check every item when you audit the Bath Gas Co.'s accounts?—I check the details.

Do you take the collector's word for them?—No; they pass through many hands before they come to the auditor. We take the details from the secretary's ledger, relying upon the secretary to check the collectors.

In the present case you knew that Archard was secretary, collector and manager?—Yes.

Therefore you knew there had been no check on details in Archard's case?—No.

Witness added that he did not consider it was an auditor's duty to wade through all these details. He had spoken to the chairman of the company about the accounts being in arrear.

Mr. Charles Comins, chartered accountant, London, called as a witness for the defence, said he had had experience of auditing gas companies' accounts since

1890, and he was also director of several gas companies. The paramount duty of an auditor was to see that the printed accounts and balance sheet were accurate and agreed with the books and showed the true position of the company. There was no royal road as to methods that should be adopted by an auditor. The cash book kept by the company was not a proper cash book. It only represented accounts between the secretary and the company. It represented only receipts and payments by the secretary. It did not include receipts paid to bankers direct, nor payments made to the company by cheque. These only appeared in the pass-book. That was quite irregular, and quite useless. He had never seen that done before. Such practice made it more difficult to detect fraud. So far as he was able to judge, the defendant had carried out carefully and conscientiously his audit, and had done all the usual things in an audit of this character. In fact, he went beyond that, and did a great deal of detail in seeing the books were accurate. He checked the rental ledger in detail. In his experience receipt books were never checked. He did not think an auditor referred to receipt books once in a hundred times. The rental ledger gave verification of cash without going through the receipt books.

Mr. Justice Salter: Is it a part of his duty to make experimental dives or plunges?

Witness: As regards counterfoil receipt books, in the case of a gas company, I suggest not. I know in ordinary businesses you may do that, but rules that apply to ordinary businesses in regard to testing of receipts do not apply to the same extent in a gas company, because the rental ledger is its own verification of receipts of the company, in the main. Continuing, witness said undoubtedly out-standings were higher than they ought to be. That was shown clearly on the balance sheets, and there should be some explanation. The auditor should draw the attention of the directors to it. There was nothing to make one suspect fraud, as distinguished from laxity, when one examined the balance sheet. If the out-standings appeared to be properly owing, the auditor would certify the balance sheet. He had to see they were genuine debts.

In regard to the suggestion that it was improper to show arrears in respect of prepayment slot meters, witness said that the company's witnesses were quite wrong in that respect, due to the fact that they had no actual experience of auditing gas company accounts. Amounts collected in early January, which clearly related to gas consumed in the preceding quarter, were called outstanding debts. It was quite an ordinary item, and there was nothing to arouse any suspicion. In these small gas companies it was usual to include them in the current year's receipts. The accounts shown due were a reasonable sum and there was no need for the auditor to ask for an explanation. There was nothing anywhere in the plaintiff company's books to arouse the suspicion of the auditor. With regard to the fact that the cash book showed that Archard had large cash balances in the early quarters of the year, and only a small balance at the end of the year, the auditor only dealt with the cash in hand at the date he checked the balance sheet. In the absence of suspicion, he saw no reason why the auditor should test balances at the end of quarters. There was nothing to arouse suspicion. The cash book would be examined by the audit clerk. If he (witness) had seen it personally, it would not have aroused suspicion in his mind, in the circumstances that existed here. There was nothing exceptional in a gas company having a cash balance of £300 or £400 in the hands of the secretary. As to the erasures they appeared on the surface to be mere clerical errors. There was no attempt at evasion or deceit.

In cross-examination, witness said no auditor exercising ordinary skill and care could have discovered the fraud. It was the kind of fraud that was only discovered when a man went on holiday or left his employment.

Mr. Clare Smith, chartered accountant, of Bristol and London, said he was familiar with the snowball fraud, as this was called. It was a form of fraud difficult to detect in its early stages. An auditor, prima facie, was entitled to assume that books were honestly kept.

Mr. J. E. Grace, chartered accountant, Bristol, also gave evidence and this closed the defendant's case.

Mr. Foote, K.C., addressing the Court for the defence, contended that the defendant had exercised all reasonable care and skill in his work, and that was all that was expected from him.

JUDGMENT

Mr. Justice **SALTER**, in delivering judgment, said the business of the gas company was carried on in a somewhat easy-going way and on old-fashioned lines. The defendant had been auditor for plaintiffs for twenty-two years. In this case his lordship was concerned with the last ten years. From 1906 the secretary of the company was Mr. Gough, a solicitor and town clerk of Calne. Gough had in his office Archard, who assisted him. Gough had control of the affairs and the work of the company. In 1912 Gough's health failed and Archard practically took over the work, and in 1913, when Gough died, Archard succeeded him as secretary, and later was appointed manager and also collector. About this time Archard was entirely trusted by the directors. It now appeared that from and after 1906—that was long before he was secretary—Archard had commenced on a small scale a system of fraud known to accountants as the snowball fraud. During the last part of the period in question Archard was undoubtedly overworked, working on Sundays and at night, sometimes having help and sometimes himself paying for help. Defendant knew of this and remonstrated on many occasions with the chairman of the company, pointing out that Archard's work could not be efficiently done unless he had assistance. Even before the war the books of the company were getting into considerable arrear, and after the war matters were made worse. In 1917 Archard, who was entirely unsuspected up to that date, was called up for military service, and then the books were found in arrear and confusion. They were written up for audit with the result that deficiency was ascertained. Messrs. Price Waterhouse & Co. investigated the books and exposed the fraud, which had been going on for ten years. This action was brought for damages for negligence, and the company claimed as damages the amount of Archard's defalcations and the costs of the investigation.

It was important to guard oneself against approaching the matter in the light of subsequent knowledge. Defendant had no cause to suspect Archard outside the books. Whether the books ought to have put him in suspicion was the main matter he had to determine, but it was important to approach the matter from the point of view that this was an ordinary periodical audit of the books of a trusted and apparently respectable man whom there was no cause to suspect. The book-keeping methods of the company were old-fashioned and the writing up of the books was behind. The auditor was not in charge of the book-keeping, and it was not his duty to control or regulate them. His lordship was satisfied that defendant did repeatedly complain to the chairman of the company that Archard was overworked, that he had insufficient help, and that the books were not kept up to date as they should have been.

It was clear that the mere fact that a fraud was not discovered in the course of an audit was not conclusive evidence of negligence in the conduct of the audit. Defendant certified that the published accounts of the company were not merely in accordance with the books, but that they represented the true financial position of the company; but as a fact they did not, to this extent, that they overstated the amount owing to the company each year by the amount of Archard's fraud. The certificates which the defendant gave during this time were, in fact, misleading. They were certificates based upon his honest belief in the matters which he certified. **But where an auditor, in fact, issued a false certificate in the sense of an incorrect certificate, his lordship thought it rested upon the auditor to show that the belief upon which the certificate was based had not been the result of any lack of proper care or proper skill on his part in conducting the audit.** He dealt with this matter upon that footing. Therefore it rested upon the defendant to satisfy him that he brought to bear in the conduct of the audits during this period a fair average degree of diligence and care, and also a fair average degree of competence and professional skill. Defendant impressed him as a very honest man, but not a very clever man. He impressed him as a witness as scrupulous and honest, and he did himself justice in his evidence. He had come to the conclusion, considering the way this business was conducted and the duties Archard had to discharge single-handed, that the audits were conducted with fair and average diligence and care—there was no deficiency on the part of the defendant in bringing to bear a fair and proper standard of diligence and care on these audits. The company's case was this, that an auditor must audit with eyes open and alive to the accounts, and that

there was upon the face of these books a matter which should have aroused the suspicion of a vigilant and competent auditor. His lordship was of opinion that there was no lack of skill and vigilance on the part of the defendant here. Mr. Comins' evidence had satisfied him on many points. On the whole, his lordship came to the conclusion, and was satisfied that as regards industry and care the defendant had brought to bear at least a fair and average standard, and as regards competence and skill the evidence satisfied him that defendant did not fall below a fair average of competence and ability, which he was bound by law to bring to the conduct of this work. He therefore gave judgment for defendant with costs.

A stay of execution in regard to costs was granted, with a view to plaintiffs appealing if they so desired.

WALL v. THE LONDON & PROVINCIAL TRUST LTD.*

(Decided by Mr. Justice YOUNGER, in the Chancery Division, on 6th July, 1919)

Held that a company which, by its articles of association, adopts the double-account system cannot legally treat profits made on the redemption of its debentures as being available for dividend.

This was an action brought against a trust investment company to prevent it from distributing a certain discount on the redemption of debenture stock as dividend. The facts were as follows: The company had for its primary object to acquire and hold stocks, shares and securities of the classes specified in the memorandum of association, and from time to time to change such investments for others of the like nature. Another object of the company was stated to be to borrow on debenture stock and to redeem or pay off the money so borrowed. The articles provided that the accounts should be kept on the footing that profit or loss on a change of investment be carried to capital account, and net receipts over expenditure be carried to revenue account, and be available for payments of dividends without regard to any depreciation in the market value of the investments. The company in 1900 issued at par £50,000 4½ per cent. debenture stock. In 1918, owing to the general fall in the value of securities, they were able to redeem part of this debenture stock at 22 per cent. discount, and they claimed the right to carry the amount of this discount to revenue account and distribute the same as dividend. Wall challenged this claim, and sought an interlocutory injunction restraining the company from so distributing it.

JUDGMENT

YOUNGER, J., after stating the facts, in the course of a considered judgment, said: I grant the injunction. The company is one of the type of trust investment companies which are described in *Verner v. The General & Commercial Investment Trust*. The accounts were kept on the double-account system, under which any profit or loss on change of investment is not carried to revenue account. The discount on the debenture stock was never more than a book entry. It was not contended that the investments originally purchased with the proceeds of the debenture stock could be shown to have retained their original value. The defendants are content to assume that these investments might have fallen to an extent approximately equivalent to the discounts at which the debenture stock had been redeemed; but, notwithstanding that assumption, contend that they are entitled to deal with the amount of the discount as profits.

The first contention is that the power of borrowing contained in the memorandum enabled the company to treat the dealings with the debenture stock as a separate business, which has resulted in a profit measured roughly by the discount. In my opinion, that clause in the memorandum is a mere subsidiary power, and not an independent purpose or object of the company. Moreover, if it were, it would be impossible to affirm that the transaction resulted in a profit unless it were established that there remained in the hands of the company an asset equivalent in value to the alleged profit.

It was further contended that this discount represented the sums withdrawn from revenue in payment of interest on the debenture stock over and above what would have been eligible in respect of interest upon it, if from 1900 the money

* [1920] 1 Ch. 45; 63 S.J. 705.

had been held by the company at call. I fail to appreciate how a redemption by agreement in 1918 can retrospectively convert a permanent loan into an advance of money at call, relating its incidents accordingly.

The third contention was based on Article 126, which was said to constitute the measure of the company's obligations in respect of capital account, so that the company could not only distribute as profit any balance of revenue irrespective of capital depreciation, but, if it cancelled any capital liability might withdraw from capital assets and credit to revenue the equivalent amount in real value so released, without troubling to ascertain, by valuation or otherwise, whether the remaining capital assets had maintained the value attributed to them. I think that contention is inadmissible. **Where the double account system exists, no transfer can be made from one account to another. An appreciation of capital can never increase the income balance. To do this the single-account system must be adopted, which is not in accordance with the constitution of this company.** This discount is not either net profit of the company or net profit arising from its business, and the directors are not entitled to distribute it as dividend.

SAME CASE*

(Finally decided by SARGANT, J., in the Chancery Division, 23rd June, 1920)

Held, that the interlocutory injunction must be confirmed

The facts are recited above.

JUDGMENT

SARGANT, J., in the course of a considered judgment, said: The facts proved before me are in no material respect different from those disclosed in the affidavits on the motion. Apart from the special provisions of the articles of association, the directors cannot dissociate the single item of gain now in question from the items of loss and treat it as a profit susceptible of being distributed as dividend. The net result is that the company's capital is now represented by a less amount of investments subject to a smaller charge of debenture stock, and that substantially the same proportion of the issued capital is still unrepresented by available assets. Profit in the case of a company like this is not constituted by one individual gain, but by a surplus of gains of all kinds over losses of all kinds during some definite period. If it is necessary so to hold, I hold that the gain involved in the reduction of liability on debenture stock is a gain in respect of capital or on capital account, and is analogous to the losses on capital account caused by the depreciation of the investments charged by the debenture stock. Such difference, if any, as is made by the articles of association tends to accentuate the distinction between capital and income, and to prevent an item of capital gain such as this from being transferred to the credit of revenue, even if it could be segregated and dissociated from the company's previous and contemporaneous losses. I further agree with Younger, L. J., that the issue of loan capital is not, properly speaking, one of the objects or part of the businesses of the company, but is a power to be exercised incidentally to, and in furtherance of, the objects of the company, and that even if the sum in question is otherwise divisible as net profit, such a division will be prohibited by the fact that it does not arise out of the company's business. I do not wish to decide that in no event whatever (such as, for example, the event of an appreciation of the company's capital assets so as to exceed the nominal value of its issued capital) would it be possible to treat as profit and divide as dividend again of this nature, especially if an alteration was made in the company's regulations. There must be a declaration that the amount of discount was not, nor was any part of it, available for distribution as dividend or for transfer to any account called revenue, revenue account, or otherwise designated so as to imply that the said sum or any part thereof was so available. An injunction must be granted to restrain the company and its directors for the time being from distributing the said sum or any part thereof as dividend, and from transferring or keeping transferred the said sum or any part thereof to the credit of any such account as aforesaid.

* 64 S.J. 635.

WELD-BLUNDELL v. STEPHENS*

(Decided by the House of Lords, before Lords FINLAY, PARMOOR, DUNEDIN, SUMNER and WRENBURY, on 13th May, 1920)

Held that an agent who causes his principal loss by the inadvertent publication of a libellous letter by the latter is liable in damages

Appeal from an order of the Court of Appeal (Bankes and Warrington, L.J.J., Scrutton, L.J., dissenting) (60 *The Accountant* L.R. 8), setting aside a judgment of Darling, J., and giving judgment for the appellant for nominal damages.

In this case Mr. Charles Joseph Weld-Blundell brought an action against the defendant, Mr. J. H. Stephens, chartered accountant, of Clement's Lane, E.C., claiming damages for an alleged breach of duty or negligence in the performance of his duty as his servant or agent in the capacity of accountant or auditor.

The defence was a denial of the alleged breach of duty or negligence and Mr. Stephens counterclaimed for £45 for services rendered.

The short facts were these: in 1915 Mr. Weld-Blundell was interested in a private company called the Float Electric Co. Ltd. The company was not successful and Mr. Weld-Blundell, who had financed it to the extent of £13,000, was dissatisfied and employed Mr. Stephens to investigate the affairs of the company and advise him. During the course of the investigation Mr. Weld-Blundell wrote to Mr. Stephens a letter of instruction, which contained matter defamatory of a Mr. Comins and a Mr. Lowe, who were connected with the management of the company. A few days later the contents of the letter became known to both these gentlemen, who accordingly brought libel actions against Mr. Weld-Blundell which cost him £1,869 in damages and costs.

Mr. Stephens' case was that he showed Mr. Weld-Blundell's letter to Mr. Swift (Mr. Stephens' partner) who took it to the company's offices, doubtless for reference while making investigations for Mr. Weld-Blundell, and that Mr. Swift lost the letter. In these circumstances he contended he had committed no breach of duty and no negligence in giving his partner Mr. Weld-Blundell's letter to enable him to obtain from the bank the particulars of the company's accounts, which Mr. Weld-Blundell desired. The jury returned a verdict for Mr. Weld-Blundell, assessing the damages at £650. They said that in their view the conduct of Mr. Weld-Blundell had conduced to the large amount of damages given against him in the libel actions.

In the King's Bench Division, Darling, J., gave his considered judgment in favour of the defendant. He said that the letter out of which the action arose was written and published on a privileged occasion but the jury had found that it was written and published with malice in the legal sense. The jury had also found that it was the duty of the defendant to keep the letter secret and that the defendant neglected his duty in regard thereto. They further found that the actions for libel brought by Lowe and Comins against the plaintiff and the damages recovered by them were the natural consequences of the proved negligence of the defendant. His lordship stated that the tort which the plaintiff committed and suffered by was the wrong of writing and publishing with legal malice a libel which, but for the proof of his malice, would have been protected by the privilege of the occasion. It was therefore contended on behalf of the defendant that plaintiff could not have judgment on the ground that the injury sustained by the defendant was traceable to his own unlawful act. So far as his lordship was aware there was no decision which covered this case. The defendant Stephens had no part in the composing of the libel nor was he actuated by malice in the receiving of it, nor in such publication as he made of it. His lordship could not therefore regard the defendant as joint tortfeasor with the plaintiff, since in the matter he committed no tort whatever. The real cause of the present action was the defendant's carelessness with his custody of a document conveyed to him in the duty he had undertaken.

'After much consideration', concluded his lordship, 'I have come to the conclusion that our law does not and cannot imply any such terms or term as that which the plaintiff alleges and that therefore no breach of contract or derelection of duty was committed by the defendant.' He therefore gave judgment for the defendant.

The Court of Appeal (Scrutton, L.J., dissenting) came to the conclusion that

* [1920] A.C. 956; LXIII *The Accountant* L.R. 14.

Darling, J., was right in saying that Mr. Weld-Blundell could not recover any portion of the special damages which he claimed, but as he has proved a cause of action in contract he was entitled to nominal damages of 20s. upon that head, but in the circumstances without costs. The appeal was therefore allowed.

On appeal to the House of Lords, the House, by a majority, dismissed the appeal.

JUDGMENT

Lord FINLAY said it was not disputed that the respondent was guilty of a breach of duty as agent, and that the direct consequence of that breach was the bringing by two gentlemen of actions for libel which, but for the respondent's breach of duty, would never have been brought. There was no legal principle to exclude the damages in such actions from being taken into account in estimating the damages payable by the agent. To hold that no such damages could be recovered would be to give practical immunity in many cases to agents who had allowed the secrets of their principals to become known. This was an action for breach of duty by an agent in failing to take proper care of a document entrusted to him. It was admitted that he had failed to discharge that duty, and the very thing happened which it was his duty to guard against. The appeal should be allowed, and judgment for £650 entered for the appellant, with costs.

ARTHUR E. GREEN & CO. v. THE CENTRAL ADVANCE AND DISCOUNT CORPORATION LTD.*

(Decided by Mr. Justice SHEARMAN in the King's Bench Division, on 22nd-29th April, 1920)

Held that in certain circumstances the auditors of a company may be held negligent for accepting schedules of bad debts supplied to them by the managing director

This was an action brought by Messrs. Arthur E. Green & Co., incorporated accountants, of Moorgate Station Chambers, E.C., for the recovery of fees against the Central Advance and Discount Corporation Ltd., of Charing Cross Road, London. There was a counterclaim by the defendants, based on allegations of negligence in the preparation of accounts.

The facts sufficiently appear from the judgment.

JUDGMENT

Mr. Justice SHEARMAN, giving judgment, said that the action was brought by the plaintiffs to recover three sums claimed to be due to them partly for agreed auditors' fees, and partly for certain special services rendered. The defence to a considerable portion of the claim was that the work done was of no value owing to the negligence or breach of duty of the plaintiffs, and the defendants counter-claimed against the plaintiffs for breach of their duty as auditors to the company. There were numerous issues in the case, but obviously the key to the solution of most of the issues was the question whether the plaintiffs had been guilty of a breach of their professional duty. The debts of the defendant company were usually secured by sureties, sometimes by bills of sale or the deposit of small leases. The defendant company's business was of a conservative kind, and not particularly speculative. The plaintiffs had been the auditors to the company for a great many years, and it was agreed that they should be paid so many shillings for each schedule or sheet of debtors. It was clear to both contracting parties that one of the duties of the auditors was to extract a schedule of debtors in order that the present value of the outstanding debts for the purpose of getting out the balance sheet might be ascertained. At all times material to the action Mr. Foot was the manager of the company, and he was also a director.

He could see no evidence, his lordship proceeded, that the plaintiffs were retained to do anything other than act as auditors for the company, and he was satisfied that everybody on both sides was desirous of attending to his duty, and was scrupulously honest. He regretted that during the controversies that arose in the case—although not in that Court—charges of dishonesty were made against the plaintiffs, and he was satisfied that these charges had no foundation. The directors of the company were business men, and regularly attended meetings of

* *The Accountant* L.R., Vol. LXIII, p. 1.

the board, sometimes once and sometimes more than once a week. He found that what they did was to examine the position of the borrowers, and none of the directors made himself acquainted with or looked into the question of there being a large amount of old debts, to find out how old these debts were or how unproductive. At the same time the auditors were perfectly well aware that the directors were meeting, and, he thought, were entitled to assume that the directors were attending to what was obviously a part of their business. With regard to the auditors, the financial year of the company ended in February, and at the end of every six months the auditors presented a tentative balance sheet, which came before the board, and after the directors had considered it there was a printed balance sheet, which was certified. The form of the certificate throughout was substantially the same, and it ran in this form: 'We report to the shareholders that we have examined the above balance sheet with the books of the company, and we have obtained all the information and explanations that are required. In our opinion such balance sheet is properly drawn up so as to show a correct view of the company's affairs, according to the explanations given to us, and as shown by the books of the company.' Mr. Foot died in the summer of 1917, and as soon as he died Mr. Green came before the directors and reported to them and produced a document in which he showed most conclusively, as was the fact, that a very large amount of perfectly unproductive debt was standing on the balance sheet which he presented. He (the judge) had the paper before him, and at the end of one part appeared £19,000 of debts of which he was satisfied the major part were utterly useless assets and of no value at all. A great many had been on the books for a great number of years. The directors, besides attending from time to time, had what they called bad debt meetings, and a very serious problem for them to consider was this: he (the judge) was perfectly satisfied that for a number of years the accounts presented showing a large part of assets and a comparatively small percentage to reserve for bad or doubtful debts did not present a true account of the state of the company. He had to consider whether that was due to negligence of the auditors.

The duty of the auditors was quite clear as to statutory duties. They had to make a report, and state whether in their opinion the balance sheet was properly drawn up so as to afford a true account or statement of the company's affairs. **It was said by the company, and he acceded to the view, that the auditors belonged to a profession, a respected profession; that they were not only to be honest, but were bound to exercise an extraordinary skill, but there was a standard. They were professional people advising a company, appointed by the shareholders to do so. They had to exhibit a standard of professional skill, and if they did not come up to that standard that was for the judge or jury trying the case against them to say, and that was always a difficult matter to try.** The case made by the directors was that they did not do certain things because they trusted to the auditors to do them. The case for the auditors was that from time to time there was a bad debts meeting of the directors to consider a certain list which was prepared by the managing director. They said the directors must know more about the assets than they could know, and that they were entitled to rely upon the directors; that they had no reason to suspect Mr. Foot. The auditors said that when the list of bad debts came back to them for them to settle the final balance sheet, Mr. Foot had struck out some of the people they had put in in respect of bad debts. Mr. Foot had been described as a man who would brook no interference, and he (the judge) could not help thinking that when the directors struck these names out of the list it was upon the instructions or advice of Mr. Foot. It had been said that Mr. Foot stood to gain by being optimistic as to the state of the company's affairs. There was an article which gave the company power, after 15 per cent. had been earned, to declare a bonus to the managers, and for four years such a bonus had been voted by the directors in this way. Obviously, it was to Mr. Foot's advantage to show large balances in order that the directors' discretion might be exercised by awarding such a bonus to Mr. Foot himself. He (the judge) had to look into the whole circumstances of the case in order to decide whether the auditors had been guilty of a breach of duty in certifying what they had certified to be a true state of the company's affairs, which he (his lordship) was satisfied it was not.

He had gone into the question very carefully, and he noticed that at one period, as late as 1913, a document was produced, and figures as to bad debts had been filled up by the plaintiffs, and a part of these had been struck out and put back again into the list of good debts, subject to reserve, at any rate, after it had been before the directors' meeting. He did not want to go into all the details, but the conclusion he had come to was that the plaintiffs were guilty of a breach of duty in the last two years complained of. There were some special circumstances connected with that. On his own initiative, Mr. Green, with his partner, had produced a large list and sent it to Mr. Foot, showing thousands of pounds of unproductive debts, and he (the judge) could not have any doubt that they were uneasy about it, and they put it before Mr. Foot, because they were satisfied it ought to be dealt with. Mr. Foot took that away to his private house, and the directors never saw it. All they were told, both by Green and by Soul,* was that they made inquiries of Foot, and that he said he was too busy to attend to it, but the result was that after having no information afforded them about what were unproductive debts, the auditors went on in the old style, issuing a balance sheet which did not even show the shareholders the amount set aside to reserve. Everything which appeared on the books was put down as an asset. They were divided into different items. There were the balances due from borrowers, and the different items of which they had been made up, and also charges and County Court costs, which merely represented County Court costs which had been incurred in respect of various debtors. Many of these charges were in respect of debts which had failed to produce anything, and they were all put down as assets. **The conclusion he had come to was that the auditors, having made inquiries, did not get any satisfactory explanation. It was said that they were entitled to believe that in a money-lending business it did not matter how old the debts were, because in the long run people would come back and pay in order to be able to obtain further advances. He did not think that was a satisfactory explanation at all.** There were thousands of pounds of statute-barred debts, and the idea that people would come up and pay them because they would want to be able to borrow from that company, and not from another, was not one he could accept. He had, therefore, come to the conclusion that the defendants' counterclaim must succeed.

The first part of the plaintiffs' claim was for services rendered in getting out a balance sheet which he was satisfied was useless and the claim was for £92, with the exception of three guineas, which must come off. It was then said that the directors continued the services of the auditors to set all this right, and for some months the directors went on utilising the services of the auditors, and they got out a statement which he was satisfied did represent a true state of the company's affairs, according to their belief and skill. It did enlighten the shareholders, and the company got the benefit of it. He thought some portion of that was after some other auditors had looked into the books and that some portion of the hours for which they charged were concerned with attendances they made. Some of the attendances were to explain their own position with regard to it, but the directors must have known. Plaintiffs had written to offer their services to assist, and the other auditors had asked them to come in, and they did indeed present the new accounts. Another item was for further attendances of the plaintiffs to do work. There were some unfortunate controversies going on, and neither party behaved with the greatest discretion. The directors took the view that they were not going to pay anything, and that, no doubt, irritated Mr. Green, who no doubt was honest, and skilful in his profession. Mr. Green then said as an act of grace he would allow the balance sheet to go out, and eventually Mr. Green did certify, and the accounts, which the directors were satisfied with, were duly presented to the company. There was a dispute then about the schedules. The directors put other accountants there. They had all the accounts before them, and he could not think they did not accept the work which the auditors for the last six months had done. He did not like to direct an inquiry, but he proposed to give Mr. Green 150 guineas with regard to his claim.

The only question that was left to him now, proceeded his lordship, was the question as to the schedules, and whose property they were. He thought that was quite immaterial to this inquiry, and that the defendants were entitled to damages

* Partner of the Auditor.—Ed.

of one shilling for the detention of the schedules. He understood that they would be handed over, and no question would arise.

The result was that there would be judgment for the plaintiffs for £157 10s. on the claim, and judgment for the defendants on the counterclaim for £613 14s. 11d. Plaintiffs would have the costs of the action, and defendants the costs of the counterclaim. He desired to say, with regard to the cases that had been cited to him, that there did not seem to be any reported cases in which the exact duties of auditors with regard to dealing with book debts were laid down. He thought it must rest upon the general principles of the law on professional negligence. One had to fall back on the words of the statute. If there were circumstances which seemed to call for inquiry, the auditor must make the proper inquiry, and if he did not take the proper steps to have the matter sifted, he did not fulfil the duty he owed to the company as one of its officers. He (the judge) regretted very much that Mr. Green's firm, possibly owing to the masterful nature of Mr. Foot, fell short of that standard, but he could not help arriving at that conclusion, and he therefore found as he had stated.

Mr. Storry Deans: The defendants had to employ another auditor. Does your lordship make any allowance for it?

His lordship: I have expressly left that out, as I allow nothing in respect of that. The other auditors who were called in found that everything done by Mr. Green was perfectly accurate.

CRUICKSHANK AND OTHERS v. SUTHERLAND*

(Decided by the House of Lords—Lords DUNEDIN, ATKINSON, SUMNER, WREN-BURY and CARSON, on 5th November, 1922)

Held that, on the death of a partner, his executors are entitled to a true account of the partnership assets and are not bound by any conventional or arbitrary method of valuing such assets provided by the partnership agreement. In the absence of evidence of any uniform usage to the contrary, the assets should be taken at their fair value to the firm at the date of the account and not at their value as appearing in the books of the partnership.

This was an appeal from a judgment of the Court of Appeal affirming a judgment of Peterson, J. The deceased partner, the testator, who died in 1916, by his will appointed the appellants his executors and trustees. The partnership in question had been constituted by an indenture made in July, 1914, between the testator and the remaining partners, the respondents. Under clause 13 of the indenture a full and general account of the partnership dealings for the previous year and of its property, credits and liabilities, was to be made on each 30th April, and it was provided that each partner should be bound by the account, with the single exception that any obvious error might be corrected within a year. Clause 15 of the indenture provided that the share of a retiring partner should be ascertained by the preparation of an annual account in the terms of clause 13; and clause 16 laid down, as regards a partner who died, that his share of the partnership, and of its profits made up in the usual way to the 30th April next after his death, was to be ascertained as provided by clause 15.

During the year ended the 30th April, 1915, the value of the firm's investments remained practically stationary, and the account for that year was based largely on the existing figures, and before the end of the next accounting year the testator was so ill that he was unable to do any business or to take any interest in the account.

For the appellants it was claimed that during the next accounting year (during which the testator died) the value of the firm's assets had risen considerably, but that in preparing that year's account the bulk of the investments had been brought in at the original book values at which they stood in 1914.

It had been held by Peterson, J., and the Court of Appeal that in making up the partnership account for the year ended the 30th April, 1917, the value of such of the firm's assets as consisted of shares and debentures in the various companies specified in the admission of facts must be taken to be the value at which they appeared in the partnership books.

* H.L. (E) 92 L.J.Ch. 136; LXVII *The Accountant* L.R. 23.

Lord WRENBURY delivered the considered judgment of their lordships' House, which was that **the full and general account provided by clause 13 of the indenture was a real and not an arbitrary valuation of the firm's property, and that although for the years ended the 30th April, 1915 and 1916, the partners had been content to base the account on book values, a partner leaving the firm was not bound to accept a subsequent year's account which was also based on those values.** With regard to the bad debts suspense account it was held that the appellants were entitled to a present valuation of the various debts against which sums were held in suspense, and need not wait to see the result of the future collection of those debts, each separate debt being considered with its own special reserve, and not being aggregated. The appeal was accordingly allowed.

Re CITY EQUITABLE FIRE INSURANCE CO. LTD.*

(Decided by Mr. Justice ROMER in the Chancery Division, on 22nd May, 1924)

Auditors—Whether officers of the company—Duty as to verification of securities—Alleged negligence in preparation of balance sheets—Companies (Consolidation) Act, 1908—In re London & General Bank (No. 2) ([1895] 2 Ch.) followed.

In this case the Official Receiver as liquidator sued the directors and auditors in respect of alleged misfeasance. The company had carried on reinsurance business and the chairman was one Bevan who was convicted of fraud in connection with balance sheets of the company. He was also senior partner in Ellis & Co., the company's stockbrokers, and at all the times referred to in the case this firm was largely indebted to the company. The balance sheets complained of were those of February, 1919, 1920 and 1921. Against the auditors the following claims were made: (1) that in the balance sheets sums due from Ellis & Co., and one Mansell (the company's general manager) were misdescribed by being included under 'loans at call or short notice' or 'loans'. Part of the debt of Ellis & Co. was described as 'Cash at bank and in hand'; (2) and in fact the sums actually due from Ellis & Co. were larger than were so included; (3) that certain of the company's securities were in the custody of Ellis & Co. and the auditors failed to detect and report to the shareholders that these had been pledged by that firm to third parties.

JUDGMENT

It remains for me to deal with the charges made against the respondents, Messrs. Langton & Lepine, the auditors of the company. By paragraph 4 of the claiming part of the Points of Claim, the Official Receiver asks for a declaration that these respondents were guilty of negligence in respect of the audit by them of the balance sheets of the company for the years ending the 28th February, 1919, the 29th February, 1920, and the 28th February, 1921, respectively, and are liable to pay to the liquidator compensation for the loss sustained by the company by reason of such negligence and breach of duty. The Official Receiver also asked for a declaration that such compensation included the dividends paid in respect of the year ending 28th February, 1921, as having been paid out of capital. Mr. Topham, at the end of his reply, however, stated that he did not press for any separate relief in respect of these dividends, but merely for a general inquiry as to the damages sustained by the company by reason of the auditors' negligence. But in any case, as I have already pointed out, the Official Receiver has not proved that the dividends were in fact paid out of capital.

Now the negligence and breach of duty charged at the bar against the auditors in respect of their audit of the three balance sheets in question come under three heads: (1) Their misdescriptions in the balance sheets of the debts of Ellis & Co. and Mansell by including them under 'Loans at call or short notice' or 'Loans', or in the case of part of Ellis & Co.'s debt under the heading of 'Cash at bank and in hand', and their consequent failure to disclose to the shareholders the existence of those debts. (2) Their failure to detect the fact that much larger sums were in the hands of Ellis & Co. at the date of each of the balance sheets than were so included. (3) Their failure to detect and report to the shareholders the fact that a number of the company's securities, which were in the custody of Ellis & Co., were being pledged by that firm to its customers.

* [1925] Ch. 407; 68 *The Accountant* L.R. 53.

I will deal presently with each of these matters in turn, but before doing so, there are one or two general observations about the auditors that must be made. The audit in each of the three years was in fact conducted by Mr. Lepine alone. His partner, Mr. Langton, had conducted the audits of the accounts of the company from the date of its incorporation until the completion of the balance sheet for the year ending 28th February, 1917, but from that time ceased to take any active part in the audits. In the discharge of his duties in the three years 1919 to 1921, Mr. Lepine, speaking generally, displayed great skill, care and industry. Eloquent testimony of this is furnished by the numerous accounts, memoranda, and reports which he prepared in connection with the three audits, and which were produced by him in the course of his evidence. Each audit took from six to eight weeks to complete, and during that time two or three clerks of the auditors would be in continuous attendance at the company's offices. The work of these clerks would, of course, be done under the direction of Mr. Lepine, who, during the latter part of the audit, was himself in fairly continuous attendance. The late Mr. van de Linde, who was himself an accountant of great experience, and who, after the company went into liquidation, made an able and thorough examination of the company's affairs, testified as to the care and accuracy displayed by Mr. Lepine in the audits. But if in the course of these long and arduous audits Mr. Lepine has in even one instance fallen short of the strict duty of an auditor, he cannot, I apprehend, be excused merely because in general he displayed the highest degree of care and skill. As to what that duty is there is not much authority to be found in the books. But in *In re London & General Bank* (No. 2), reported in [1895] 2 Ch. at page 673, Lord Justice Lindley dealt at some length with the duties of the auditor of a company. He says this: 'It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain that position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books themselves show the company's true position. He must take reasonable care to ascertain that they do so. Unless he does this, his audit would be worse than an idle farce. Assuming the books to be so kept as to show the true position of a company, the auditor has to frame a balance sheet showing that position according to the books and to certify that the balance sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. This is quite in accordance with the decision of Mr. Justice Stirling in *Leeds Estate Building & Investment Co. v. Shepherd* (36 Ch.D. 802). An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company. If he did, he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part, say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this. Such I take to be the duty of the auditor; he must be honest—i.e. he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient, and in practice I believe business men select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary; but still an auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert

where special knowledge is required. Mr. Theobald's evidence satisfies me that he took the same view as myself of his duty in investigating the company's books and preparing his balance sheet. He did not content himself with making his balance sheet from the books without troubling himself about the truth of what they showed. He checked the cash, examined vouchers for payments, saw that the bills and securities entered in the books were held by the bank, took reasonable care to ascertain their value, and in one case obtained a solicitor's opinion on the validity of an equitable charge. I see no trace whatever of any failure by him in the performance of this part of his duty. It is satisfactory to find that the legal standard of duty is not too high for business purposes, and is recognised as correct by business men.' I must now inquire whether, in the matters complained of, Mr. Lepine fell short of the duty of an auditor as so explained and defined.

On the 28th February, 1919, Ellis & Co., according to the books of the company, owed the sum of £51,423 and Mansell the sum of £6,225. Both these sums were included by Mr. Lepine in the balance sheet as of that date under the description 'Loans at call or short notice, £177,648'. Now it is said that neither of these sums was a loan at call or short notice. Mansell's debt certainly was not. Ellis & Co.'s probably was. But I do not propose to decide this question, for I cannot see that any human being has been misled by referring to these debts as 'Loans at call or short notice', rather than as 'Loans'. If the description of them in the balance sheet as 'Loans' would have induced any director or shareholder to make some inquiry as to their nature, which he was induced to refrain from making by reason of their description as 'Loans at call or short notice', the matter would be different. But not only is this inherently improbable, there is actual evidence that it was not so, for in the balance sheet of 28th February, 1921, the description was altered for a reason that will hereafter appear. No longer was there any sum brought in under the former description. The loan to Ellis & Co. and the debt of Mansell were, with some other loans, lumped together in the balance sheet under the general description, 'Loans'. and just as, in the two preceding years, no director or shareholder made any inquiry as to how the sum brought in under the description of 'Loans, at call or short notice' was made up, no inquiry was made as to the items going to make up the sum brought in under the heading of 'Loans' in 1921. The alteration in the heading did indeed attract the attention of Mr. Milligan. But the only inquiry he made was as to the reason for having so large a sum out on loan, as to which he received a very plausible explanation from Bevan. He made no inquiry as to how the sum was arrived at. The truth is the ignorance of the respondent directors and of the shareholders as to the indebtedness of Ellis & Co. and Mansell, so far as it was contributed to by Mr. Lepine, was due to his omission to call specific attention to this indebtedness in the balance sheet by mentioning both the debtors by name. But, if the directors choose to lend money to their brokers, or their general manager, there is no reason why they should not do so, nor can I see any reason why the auditor should call the attention of the shareholders specifically to the fact of their having done so. In the words of Lord Justice Lindley, an auditor has nothing to do with the prudence or imprudence of making loans with or without security. He must, of course, take care that he does not bring into his balance sheet at face value a debt that is not a good one. The credit of Ellis & Co., however, was above suspicion, and, in addition, the company held collateral security against their indebtedness to the value of over £286,000. Nor was there any reason to suppose that the debt of Mansell was not good. It was, however, unsecured, and accordingly Mr. Lepine, in his report addressed to Bevan in his capacity of the chairman of the company, called attention to the fact in these terms: 'The loans £177,648 include a sum of £6,225 due from your general manager, and for which the company do not hold any security.' Mr. Lepine, of course, intended this report to be placed before the board of directors, and was justified in supposing that this had been done. Bevan, in fact, suppressed it, but I cannot see how Messrs. Langton & Lepine can be held responsible for this. Mr. Lepine in this matter did, I think, all that it was reasonable for him to do in the circumstances.

Much of what I have said about the 1919 balance sheet applies to that of 1920. According to the books of the company, there was no balance due from Ellis & Co., on loan account on the 29th February, having regard to the fact that it had all been transferred to investment account. But after this transfer had been made,

the books showed a balance due from them on this latter account of £4,690 in respect of which the company held collateral security to the value of over £275,000. But in January of that year Ellis & Co. had debited the company with £161,000 in respect of the Brazilian ranch. Now, as already stated, the only sum that the finance committee had authorised in respect of this investment was £150,000, and this fact Mr. Lepine, with his usual care and industry, had discovered. Having noted it in one of his memoranda of queries, he had an interview with Bevan upon the matter. As a result of this interview, Messrs. Ellis & Co. addressed to the company a letter in the following terms: 'Re ranch account. You will doubtless remember that in all you have been debited in this connection £161,000, and the matter was discussed between Mr. Lepine and Mr. Bevan a few days ago. The amount has now been adjusted to your actual participation, namely, £150,000, so we have credited you the sum of £11,000 with interest from the 31st December, 1919, to the 30th instant, and the amount will appear in your statement of the 30th June.' The result of recrediting the company with the £11,000 was, of course, to increase the indebtedness of Ellis & Co. by that amount, and whether it was treated as due from them on loan account or on investment account was not very material. In the meantime Mansell's debt had increased to £52,427. In the balance sheet this sum, and the £11,000 due from Ellis & Co., are included in a sum of £387,564 brought in under the description of 'Loans at call or short notice.' The balance due from Ellis & Co. on investment account is included in a sum of £270,000 odd described as being 'Cash at bank and in hand'. Mr. Lepine seems to have thought that this sum in the hands of the company's brokers was as much cash in hand as if it had been in the hands of one of the company's officials. In this I think that he was wrong, but it would have made no difference to anyone had it been included, as it could have been, under the heading of 'Loans' or 'Sundry debtors'.

But as regards the debt due from Mansell, the balance sheet is open to a criticism in no way connected with the question whether the debt ought to have been included under the heading 'Loans at call or short notice'. For the only advance to Mansell that had been sanctioned was one of £15,000 approved of at the meeting of the finance committee on the 3rd January, 1919. Mr. Lepine accordingly looked up this minute, and made inquiries of Mr. Bevan about this and numerous other matters as to which he was not satisfied after making his examination of the books and documents of the company. These inquiries were made at an interview he had with Bevan on the 2nd June, 1920. This interview is dealt with as follows in Mr. Lepine's examinations at question 7,525: '(Q) Will you tell my lord what took place between you and Bevan on the 2nd June? (A) So far as I remember, Bevan informed me that although the amount authorised by the minute of January, 1919, had been exceeded it was perfectly in order; that the directors were fully cognisant of the loan which had been made to Mansell in connection with his property, and that but for his absence from London a minute would have been passed at a board meeting by the time I had come to do the audit. (Q) That is Bevan's absence? (A) Yes. (Q) Did he say what would be done in the future? (A) He told me that a minute would be passed at the next board meeting, and some agreement entered into with regard to the matter generally. I asked him to confirm that, as to the deeds being in his possession. I asked him to confirm that by letter. (Q) One of the queries you raised was as to the security? (A) Yes. (Q) Was anything said about security? (A) Yes, he told me he held the deeds in his office. (Q) What deeds? (A) The deeds of the property which Mansell had purchased. (Q) I see there is a letter from Mr. Bevan about this matter on the 2nd June, 1920, the same day? (A) It was written on the same day. (Q) Was it written after the interview? (A) Yes. (Q) It is page 10 of bundle 43: "I write to say in connection with the loan made by the City Equitable to the manager, Mr. Mansell, we hold certain deeds representing the properties he has purchased in Kent, which, of course, also cover the stock and any other assets on the property." Mr. Bevan having told you that, and having confirmed it in writing in this way, had you any reason to suppose that it was untrue? (A) No, not at all. (Q) I see you wrote in answer to that on page 702 a letter of the 3rd June to Mr. Bevan: "I am obliged by your four letters of the 2nd instant with reference to various investments made by the above company up to 29th February last. With regard to the loan to Mr. Mansell, this amounted to £52,427 14s. 3d. as at 29th February last,

which figure has been arrived at after deducting the amount due to him for profit commission for the past year; you will recollect that the only minute with regard to a loan is that of the 3rd January, 1919, which only authorised a sum of £15,000; I, however, understand that a further minute will be passed at the next meeting of the board. I will also remind you that Mr. Mansell has not been charged with any interest up to 29th February last, but that you are now giving instructions as to this'? (A) Yes. (Q) Did you accept Mr. Bevan's explanation and believe that a minute would be passed confirming these advances? (A) Yes.'

Following this interview, Mr. Lepine made a report to the chairman as in the preceding year, and this report contains the following passage: 'With regard to the loan to Mr. Mansell we would remind you that the only minute is one dated 3rd January, 1919, authorising a sum of £15,000; we understand that a further minute is to be recorded at the next board meeting. We would also draw your attention to the fact that no interest has yet been charged in respect of this loan; we, however, are informed that this matter is now having your attention, and, further, that a formal agreement is to be prepared with reference to the loan generally.' Mr. Lepine thereupon allowed the debt to be included in the balance sheet without insisting upon a minute being passed, or a formal agreement prepared. Having regard to what we now know, it is no doubt easy to criticise Mr. Lepine's action in doing this. But putting one's self into his place, and looking at the matter as it appeared to him at the time, his action was reasonable, and, except for one qualification, to which I will call attention presently, was not inconsistent with his duty as an auditor. For he had seen the slips that had been initialled by the directors who had signed the cheques in Mansell's favour, and these would seem to confirm the statement of Bevan, if confirmation were required, that the directors were fully cognisant of the loan which had been made to Mansell. The absence of a formal minute recording their approval would not, therefore, be a reason for delaying the completion of the balance sheet, or the issue of the auditor's certificate, especially as he had taken the precaution of referring to the matter specifically in the report that he thought would be shown to the board. But, as usual, this report was suppressed by Bevan, and, as usual, Bevan had lied. Not only had he lied as to the directors' knowledge, he had also lied as to there being any security, and in this lie he was ably supported by Mansell himself, for Mr. Lepine, in accordance with his practice where loans were concerned, had required an acknowledgment of the loan from the debtor. Mansell had accordingly signed a letter addressed to the company in these terms: 'Dear Sirs, I beg to confirm that as at the 28th February last the total sum which has been advanced to me on loan account in connection with my property at Pennybridge, Wadhurst, Sussex, is £52,427 14s. 3d. I am, yours faithfully, E. G. Mansell, General Manager.' The words 'in connection with his property' were the words that Bevan had used at the interview of the 2nd June for the purpose of conveying the idea that the loan was secured on Mansell's property, and though Mansell did not say in terms that the loan was so secured, he obviously intended Mr. Lepine to believe that it was. His reference to his property was otherwise meaningless. But it is just in connection with this non-existent security that the qualification to which I referred above must be added to the statement, otherwise well founded, that Mr. Lepine performed his duty as an auditor in this matter. For Mr. Lepine did not insist on inspecting the deeds of the property himself. He accepted the assurance of Bevan that the deeds were in Bevan's office. The whole question as to the duty of an auditor to make personal inspection of securities is, however, dealt with later in connection with the other charges made against Messrs. Langton & Lepine, and need not be further discussed at present.

On the 28th February, 1921, the position, even as shown in the books of the company, had changed considerably for the worse. There was then, according to the investment ledger, a sum of £350,000 owing by Ellis & Co. on loan account and £73,650 owing on investment account, while Mansell's indebtedness had increased to £96,233. As regards the latter, Bevan had not caused a minute to be passed or an agreement to be entered into, although, as has already appeared in the part of this judgment that deals with the charge against the respondent directors in connection with Mansell's loan, Bevan was already engaged in the fraudulent device which resulted in the execution of the Mansell agreement. In the balance sheet, Mansell's debt and Ellis & Co.'s debt of £350,000 were included

in an entry of 'Loans £514,633'. The securities held by the company as collateral security for the £350,000 were, on the 28th February, 1921, worth only £247,570. This, of course, did not satisfy Mr. Lepine, who raised a query upon it which was thus described in his evidence at question 7,621: '(A) The query I did raise was that on the bank certification as to the collateral security the collateral security did not come anywhere near the amount of the loan. I referred that fact to Mr. Lock, and he informed me that further collateral security had been lodged during, I think, the first week in March, and produced to me the bank's green slip acknowledging those further securities. The bank obviously could not confirm having held them on the 28th February, when they were not lodged until, I think, the 2nd or 3rd March, but I obtained from Mr. Lock, and he showed me the bank's green slip on which they used to enter securities as they were lodged, or as they were withdrawn, and I think there is a note on the account somewhere to that effect.' The note in question shows that the market price of the further securities was £104,000. From Mr. Lepine's point of view, the £350,000 was still properly described as a 'Loan at call or short notice'. But the Mansell agreement had been produced and carefully read by Mr. Lepine in the course of the audit for 1921. In view of this agreement, it was obviously impossible to describe the loan to Mansell as being at call or short notice, and so the general heading was altered to 'Loans'. This was admittedly a proper description of the £350,000, and of the sum due from Mansell, unless it was Mr. Lepine's duty to refer to the debtors by name. There was, however, no particular reason why he should have done so. He had again inspected the slips initialled by the directors, who signed the Mansell cheques, and he saw the agreement of the 4th March, 1921, and the minute of the board meeting at which it was purported to have been approved. He had satisfied himself that the £350,000 was secured. It was no part of his duty to criticise or call attention to transactions that were well within the powers of the board, and were, on the face of them, perfectly regular. He had carefully studied the Mansell agreement and had taken the trouble to prepare a fairly full abstract of its contents. He had required that the agreement should be stamped, and had made a note that the policy on Mansell's life was to be assigned to the company. Both of these requirements of his were complied with. I cannot see that his duty required him to do any more. It may at first sight seem somewhat strange that Mr. Lepine should not have made some inquiries as to the provision contained in clause 9 of the agreement, under which Mansell was freed from all further liability in case the company ceased to carry on business before the loan had been repaid out of his commission. But in February, 1921, the possibility of such an event happening must have seemed to Mr. Lepine to be so remote a contingency as not to warrant serious consideration. It is indeed to be observed that in the abstract of the agreement that he made he did not think it worth while to include that provision. The abstract does take note of the provision under which the loan was to be cancelled if Mansell ceased to be manager. But, notwithstanding this, Mr. Lepine thought that the loan was well secured. The following passage in his cross-examination in relation to the Mansell agreement, and the loan, indicates his reasons for so thinking. He was asked this at question 8,212: 'Did you think it was quite an ordinary kind of agreement? (A) I thought that the directors had considered it was in the interests of the company that Mr. Mansell should have this money, and I left it at that, I think. (Q) You left it at that? (A) Yes, except that I wanted to see that the policy referred to, the short-term policy, had been assigned to the company, and I took steps to see that that was done. (Q) You realised, of course, that if Mr. Mansell left the service of the company the liability to pay ceased? (A) Yes. (Q) Did you not consider that that was such an extraordinary matter that you should have called the attention of the shareholders to that? (A) No, I did not. It was the policy of the directors. (Q) Of course, you saw that it was only payable out of future commissions? (A) Yes, I think I did, and I think I worked it out to see if, on the new basis, there was a probability of his paying those. (Q) How long did you calculate it would take him to pay them? (A) I think the instalments are referred to in the agreement. (Q) You said you worked it out? (A) Yes, to see whether his remuneration approximately, on the past basis, as far as one could see, would in any way amount to the instalments referred to in the agreement. (Q) From that calculation did you find out how long it would take for him to repay that loan? (A) I found at the time on the past basis—

unfortunately I have not got my note here, but I think there was some considerable sum over. (Q) You put that debt in as an asset of the company for its full value? (A) Yes, at that time. (Q) It depended, did it not, upon whether Mr. Mansell continued in the employment of the company? (A) Yes; but at that time he was in the employ of the company, and the company was a going concern, and I knew how highly the directors valued his services. At that time it was a going concern, and, in my opinion, it was a perfectly good amount of expenditure.

In my opinion Mr. Lepine was guilty of no breach of duty in connection with any one of the three balance sheets in the way he dealt with the indebtedness of Ellis & Co., or the indebtedness of Mansell, subject only as to the latter, to the qualification to which I have already referred in connection with the balance sheet of 1920, and subject as to the former, to the following observation. The £73,650 shown by the company's books to be due from Ellis & Co. on investment account was included in the balance sheet in a sum of £188,000 odd stated to be cash at bank and in hand. In my opinion it was not cash in hand. It was merely money owing to the company by the brokers, and the company held no security to cover it. But Mr. Lepine had seen a letter of the 1st March, 1921, written by Ellis & Co., to Mr. Lock for the purposes of the audit, in which it was stated that £50,000 of this money had been earmarked to the company's American account (that is, for the purposes of the company's American business) for remittance during the month of May. There appeared therefore nothing to call for special remark in so large a sum being in Ellis & Co.'s hands, and, having regard to the credit and reputation of that firm, neither Mr. Lepine nor anyone else would have felt any anxiety about the money being forthcoming whenever it might be required. Mr. Lepine was cross-examined as to his justification in describing this sum as cash in hand as follows: 'Question 8,465: Do you seriously say—I want you to consider this answer—that it is proper when you are preparing the balance sheet of the company to whom the money is due to describe the money in the hands of the brokers as being cash at bank and in hand? (A) Yes. The only other alternative, I suggest, is that it might be put as "Cash at bank and in hand, and on other accounts"; that is the only suggestion that I can make as to that heading. (Q 8,466) Why "cash" at all? (A) Because it was the balance of cash in their hands. There was £50,000 which they were retaining, according to the certificate to me, to send to America. I knew they did act as agents in connection with the American business. (Q 8,647) The expression "cash" is meant to convey something that is quite liquid? (A) Yes, absolutely, I quite agree. (Q 8,468) Do you suggest that this sum of £73,000 was quite liquid? (A) Yes, I do at that time. My view was then that if the company had asked Ellis & Co. for a cheque for £73,000 on the 1st March they would have got it. (Q 8,469) Is that still your view? (A) No, not to-day; one has to judge at the time of the audit. (Q 8,470) Do you not see now, quite seriously, that this was, in the light of the facts, a serious misdescription? (A) As I know the facts to-day, yes, certainly, I agree. (Q 8,471) And you never have described such a sum as this before as cash in hand? (A) No, because I have never had such a case.' There was, therefore, a misdescription, but I should hesitate long before holding Mr. Lepine to be guilty of negligence in this respect. I need not, however, pursue this matter further because, even if the misdescription did amount to negligence, it caused no damage to the company. Had Mr. Lepine in fact included the money under the heading 'Cash at bank and in hand and on other accounts' he would not, in my opinion, have laid himself open to legitimate criticism, and the subsequent course of events would have been in no wise altered.

I now turn to the second head under which the auditors are charged with negligence in the preparation of the three balance sheets. The negligence alleged against them under this head is in effect, that they did not detect the operation carried out annually by Bevan and euphemistically referred to in the proceedings before me as the operation of 'window dressing'. A passing reference to it has already been made in this judgment. It was an operation that consisted of a pretended purchase by Ellis & Co. of Treasury bills shortly before, and a pretended resale of the bills soon after, the close of the financial year. The effect of the operation was to reduce to comparatively insignificant proportions the sum shown by the books to be due from Ellis & Co. on investment account at that date. The bills were never delivered by Ellis & Co. and indeed were never even received by them. The operation was intended, amongst other things, to deceive the auditors

as to the extent of the firm's indebtedness to the company and it succeeded in doing so. The question to be decided is, whether Mr. Lepine was guilty of negligence in allowing himself to be deceived. Now the facts relating to these pretended purchases and sales are, so far as material, as follows: On the 27th February, 1919, Ellis & Co. ostensibly purchased on their own behalf through Messrs. Kleinworts, an eminent firm of brokers, £200,000 Treasury bills for £198,576. Messrs. Ellis & Co., of course, had no intention of parting with this sum of cash, so they got Messrs. Kleinworts to make them an advance against the bills of £198,000 carrying interest at 5 per cent. to the 3rd March, when it had been arranged that Messrs. Kleinworts should sell them. On the 28th February accordingly Messrs. Ellis & Co. sent their cheque for £198,576 to Messrs. Kleinworts, who, in their turn, sent a cheque to Messrs. Ellis & Co. for £98,000. On the 3rd March Messrs. Kleinworts sold the bills for Ellis & Co.'s account for £198,000 and sent Ellis & Co. their cheque for this amount. On the same day Ellis & Co. repaid to Messrs. Kleinworts the £198,000 and interest. In the meantime Ellis & Co. had, by letter of the 27th February, informed Mr. Lock that they had purchased for the company £200,000 Treasury bills at a cost of £198,576 and had debited that sum to the company in their accounts. On the 3rd March they credited the company in the accounts with £198,600 as on a sale of such bills. The result of all this was that in the balance sheet for the year ending 28th February, 1919, there appears amongst the investments of the company £200,000 Treasury bills, and the debt of Ellis & Co. is brought in as £51,423. In truth the company never had such an investment, and the debt of Ellis & Co. should have been increased by £198,576. It should be stated in fairness to Messrs. Kleinworts that they acted quite innocently in the matter, and did not know that the company was concerned in any way with the transaction.

A similar operation was carried out in February, 1920, the amount of the Treasury bills bought from Messrs. Kleinworts on the 26th February being £390,000, the price £386,420, Messrs. Kleinworts' loan £385,000, and the proceeds of the sale of the bills on the 5th March being £386,856. In February, 1921, the operation was repeated. Treasury bills for £240,000 were bought from Messrs. Kleinworts as on the 25th February for £237,513, Messrs. Kleinworts' loan was for the same amount, and the bills were sold on the 3rd March for £237,744. In 1920 and 1921 Messrs. Kleinworts retained the bills in their own possession as security for the loan to Ellis & Co. In 1919 they would have done so had there been any bills to keep. But there were not. In the year 1921 there was in addition an alleged purchase and resale by Ellis & Co. of £200,000 National War Bonds. In point of fact both purchase and resale took place on the 4th March, through Messrs. Hopkins, Blake & Co., a firm of brokers. Notwithstanding this, Bevan sent to Mr. Lock a bought note recording the purchase as having taken place on the 25th February at a net cost of £195,501 and this sum was credited to Ellis & Co.'s investment account as on that date.

Now, these being the facts, it is said on the part of the Official Receiver, first, that Mr. Lepine ought to have discovered the fraud that was being perpetrated by Bevan merely from an examination of the company's books, and, secondly, that if he could not discover it in this way he ought to have discovered it by insisting upon an inspection of the bills. Now, Mr. van de Linde, who gave evidence on behalf of the Official Receiver upon these points, agreed, as I understand his evidence, that when Mr. Lepine was conducting the audits for the three years in question there was nothing in the books themselves from which Mr. Lepine ought to have discovered the window-dressing transactions. But, as I gather that the Official Receiver asks me to put a different construction upon Mr. van de Linde's evidence upon this point I propose, instead of considering that evidence in detail, to deal with the entries in the books themselves. The essential thing to be borne in mind considering these entries is that, at the time the audit was taking place, the books had only been made up to the close of the financial year. When therefore Mr. Lepine in the months of April and May was conducting the audit for the year ending 28th February, 1921, he would see recorded in the investment ledger a purchase on the 25th February of £240,000 treasury bills. But the sale of these bills on the 3rd March would not be so recorded, for the entry of the sale would not be made until after the audit was closed. There would, of course, also be recorded in the ledger the sale in March, 1920, of the £390,000 treasury bills, and

the treasury bills account in the ledger would show that between then and February, 1921, no further transactions in treasury bills had taken place. There would be nothing, however, in this circumstance to make Mr. Lepine suspicious unless he happened to remember that he had observed something similar when he was conducting the audits of 1919 and 1920. But to suggest that he was guilty of negligence because in 1921 he failed to recollect what he had seen in 1920 is, I think, to lack a sense of proportion. If Mr. Lepine's duty had been confined to the audit of the treasury bills account I could understand the suggestion. But when the magnitude of his task in each year is really understood, the suggestion of negligence in this respect cannot be sustained for one moment. It is, however, pointed out that when conducting the audit for the year 1921, Mr. Lepine had before him in one and the same folio of the investment ledger treasury bills account, the records of the sale in March, 1919, the purchase in February, 1920, the sale in March, 1920, and the purchase in February, 1921, and that, apart from all question of memory he was negligent, when conducting the 1921 audit, in not seeing all these four entries, and drawing from them the obvious conclusion. When looking at this folio—it is folio 105—merely for the purposes of this case, I agree that the entries, which are few, do plainly lead to the conclusion that window dressing was taking place. But I cannot see that Mr. Lepine, when looking at the folio for the purposes of his 1921 audit, was in any way negligent in not arriving at the same conclusion. In conducting the audit for one year, he had enough to do in all conscience without looking again at the entries that he had examined, checked and ticked off in the books in the audit of the year before. I cannot hold the auditors guilty of negligence because Mr. Lepine did not discover Bevan's fraud in the matter of window dressing from his inspection of the company's books. Ought he then to have discovered it by insisting on an inspection of the treasury bills and, in the case of the year 1921, of the National War Bonds? What he did in fact in each of the three years in question was to accept a certificate from Ellis & Co. that on the 28th or 29th February, as the case might be, they held, on account of the company, the treasury bills and National War Bonds, as well as various other securities of the company that were or were supposed to be in their possession. Mr. Lepine did not insist on a personal inspection of these various securities. Had he done so, he would have discovered that the bills and bonds had been sold soon after the date of the purchase, and the window-dressing nature of the transaction would have been made clear. The question of whether he was justified in accepting these certificates from Ellis & Co. instead of inspecting the bills and bonds personally raises the whole question as to the duty of an auditor in relation to inspection, and must be considered in connection with the third head under which Messrs. Langton & Lepine are charged with negligence. The charge under that head is, in effect, that the auditors are responsible for the damage occasioned to the company, amounting to some £47,000, by reason of the pledging by Ellis & Co. to their customers and the consequent loss of various securities of the company in the possession of that firm. It is said by the Official Receiver that this loss would not have occurred had Mr. Lepine insisted on personally inspecting the securities instead of accepting Ellis & Co.'s certificates, and the Official Receiver makes the charge that, in not undertaking this personal inspection, Mr. Lepine was guilty of negligence. With this charge I must now deal.

That it is the duty of a company's auditor in general to satisfy himself that the securities of the company in fact exist and are in safe custody cannot, I think, be gainsaid. If authority for the proposition be required, it may be found in the passage from Lord Justice Lindley's judgment in the *London & General Bank* case, which has already been referred to. The auditor in that case, amongst other things, 'saw that the bills and securities entered in books were held by the bank', and this the lord justice plainly treated as being part of an auditor's 'legal standard of duty', though he did not of course mean that in all cases the bills and securities should be lodged with the bank. He meant 'with the bank or in other proper custody'. Nor is it at all clear whether the lord justice meant that in all cases the securities should be personally inspected by the auditor. For an auditor may 'see' that the bank holds the securities in the sense that he satisfies himself of the fact. In the case of a responsible and reputable bank this, according to the evidence of Mr. van de Linde, would seem to be the custom of

the auditors. *But I think it is a pity that there should be any such custom. It would be an invidious task for an auditor to decide as to any particular bank whether its certificates should be accepted in lieu of personal inspection. The custom, too, at once raises the question, much debated in the course of the evidence before me, whether the courtesy of accepting a certificate should be extended to an insurance company or a safe deposit company. Indeed, if once it be admitted that, in lieu of inspecting the securities personally, the auditor may rely upon the certificate of the person in whose custody the securities have properly been placed, the auditor would be justified in accepting the certificate of any official of the company who happened to be in charge of the safe in which the securities are placed, supposing such official to be a reputable and responsible person. At some time or another it will, I think, have to be considered seriously whether it is not the duty of an auditor to make a personal inspection in all cases where it is practicable for him to do so, whatever may be the standing and character of the person or company in whose possession the securities happen to be. I do not, however, propose to investigate this question further upon the present occasion. For an auditor is not in my judgment ever justified in omitting to make personal inspection of securities that are in the custody of a person or company with whom it is not proper that they should be left. Whenever such personal inspection is practicable, and whenever an auditor discovers that securities of the company are not in proper custody, it is his duty to require that the matter be put right at once, or, if his requirement be not complied with, to report the fact to the shareholders, and this whether he can or cannot make a personal inspection. The securities retained in the hands of Ellis & Co. for periods long beyond the few hours in which securities must necessarily be from time to time in the possession of the company's stockbrokers were not in proper custody. That Ellis & Co. were at all material times regarded, and reasonably regarded, by Mr. Lepine as a firm of the highest integrity and financial standing is not to the point. A company's brokers are not the proper people to have the custody of its securities, however respectable and responsible those brokers may be. There are, of course, occasions when, for short periods, securities must of necessity be left with the brokers, but the moment the necessity ceases the securities should be lodged in the company's strong room or with its bank, or placed in other proper and usual safe keeping. In my judgment, not only did Mr. Lepine commit a breach of his duty in accepting, as he did, from time to time the certificates of Ellis & Co. that they held large blocks of the company's securities, but he also committed a breach of his duty in not either insisting upon those securities being put in proper custody or in reporting the matter to the shareholders. This was negligence, and but for article 150,† it would be my duty so to declare and to order Messrs. Langton & Lepine to make compensation for all the damages that such negligence caused to the company, directing an inquiry to ascertain what those damages were. For it is settled by authorities that are binding upon me that an auditor is an officer of the company within the meaning of Section 215 of the Companies (Consolidation) Act, 1908, though Mr. Stuart Bevan, while admitting that it was not open to him to argue the contrary in this Court, reserved to his clients the right to contest the point in a superior one.‡ But article 150 in express terms includes the auditors

* In connection with this portion of Mr. Justice Romer's judgment, reference should be made to the rather different language used in the Court of Appeal by the Master of the Rolls towards the end of the judgment.—Ed.

† Section 152 of the Companies Act, 1929 (now Section 205 of the Companies Act, 1948) removed Auditors from the protection of such an Article. The terms of the article were: 'The Directors, Auditors, Secretary and other officers for the time being of the Company, and the trustees (if any) for the time being acting in relation to any of the affairs of the Company, and every of them, and every of their heirs, executors and administrators, shall be indemnified and secured harmless out of the assets and profits of the Company from and against all actions, costs, charges, losses, damages and expenses which they or any of them, their or any of their heirs, executors or administrators shall or may incur or sustain by or by reason of any act done, concurred in or omitted in or about the execution of their duty, or supposed duty, in their respective offices or trusts, except such (if any) as they shall incur or sustain by or through their wilful neglect or default respectively, and none of them shall be answerable for the acts, receipts, neglects or defaults of the other or others of them, or for joining in any receipts for the sake of conformity, or for any bankers or other persons with whom any moneys or effects belonging to the Company shall or may be lodged or deposited for safe custody, or for insufficiency or deficiency of any security upon which any moneys of or belonging to the Company shall be placed out or invested, or for any other loss, misfortune or damage which may happen in the execution of their respective offices or trusts, or in relation thereto, unless the same shall happen by or through their own wilful neglect or default respectively.'—Ed.

‡ Presumably because the point was decided by the Court of Appeal (in *Re London and General Bank.*)—Ed.

of the company in the protection that it gives, and it must be taken to be one of the terms upon which the auditors were employed and gave their services. They are therefore protected, unless the negligence of Mr. Lepine in the matter was wilful. This it certainly was not, unless I am mistaken as to the true meaning of the phrase 'wilful negligence'. I have heard Mr. Lepine's evidence in the witness box, and I have inspected many of the numerous documents prepared by him for the purposes of the audits that he conducted. I am convinced that throughout the audits that he conducted he honestly and carefully discharged what he conceived to be the whole of his duty to the company. If in certain matters he fell short of his real duty, it was because, in all good faith, he held a mistaken belief as to what that duty was. As against him and his partner, the application of the Official Receiver must accordingly be dismissed.

It only remains to deal with the costs of this application. As against the respondent Bevan, the Official Receiver is entitled to an order for payment of his costs, except in so far as they have been increased by reason of the joinder of the claims against the other respondents. As regards the costs of the other respondents I order the Official Receiver to pay them out of the assets, and also to retain out of the assets his own costs, so far as he does not recover them from Bevan. I am aware that there have been cases in which the Court, while unable to fix a director with liability for breach of duty, has, nevertheless, left him to pay his own costs as a penalty for conduct in his capacity of director of which the Court did not approve. In the present case both the auditors and the respondent directors failed in some matters to perform their strict duty, and but for the provisions of article 150, I should have had, in respect of those matters, to grant some relief to the Official Receiver. But it would not, in my opinion, be right on this ground to refuse to give them their costs. If I were to do so in such a case as the present, I should in effect be depriving them to a material extent of the protection which that article affords, and for which they must be deemed to have stipulated as a condition of the service that they undertook to render.

THE CITY EQUITABLE FIRE INSURANCE CO. LTD.*

(Decided by the MASTER OF THE ROLLS, Lord Justice WARRINGTON and Lord Justice SARGANT in the Court of Appeal, 11th July, 1924)

Auditors—Whether officers of company—Duty as to verification of securities—Alleged negligence in preparation of balance sheet—Companies (Consolidation) Act, 1908.

The Court dismissed this appeal by the Official Receiver as liquidator of the City Equitable Fire Insurance Co. Ltd. from a decision of Mr. Justice Romer (reported at 68 *The Accountant* L.R. 53) dismissing the summons taken out against Messrs. Langton & Lepine, the auditors of the company, for an order that it might be declared that they were guilty of misfeasance and breach of trust and for consequent declaration as to their liability.

JUDGMENT

THE MASTER OF THE ROLLS: This case is important in the sense that it has arisen in the course of the liquidation of a notable reinsurance company with many and considerable liabilities. The company was at one time prosperous, and in a short time it was brought to a tragic end by the fraud of its chairman, who was later convicted and sentenced to a term of imprisonment. Its downfall involved many persons in its ruin and consequent suffering to them. But although no development of the law is involved in its termination and the problems raised can be solved by the application of principles already well ascertained, it involves only an application of them to the facts and it forms only an illustration of how those principles are to be applied. In the course of the liquidation of the City Equitable Co. summonses for misfeasance under Section 215 of the Companies (Consolidation) Act, 1908, were taken out by the liquidator against the directors of the company and against Messrs. Langton & Lepine, who had for some years acted as auditors of the company. Messrs. Langton & Lepine are auditors of good standing in the City of London, and the appeal is in respect of a judgment

* [1925] Ch. 407; 68 *The Accountant* L.R. 81.

given by the learned judge upon the case as presented against them. The learned judge, Mr. Justice Romer, after a long and careful trial, came to the conclusion that the liquidator was not entitled to recover from the directors, and the result of his judgment was the same as against the auditors. But the liquidator has appealed before us claiming that the judgment of Mr. Justice Romer, so far as it has held that the auditors were not liable, ought to be reversed.

Now I do not propose to restate all the facts. Mr. Justice Romer, in a judgment which deserves more than a passing word of appreciation for its grasp of the details of a long and complicated case and its co-ordination of the facts, as well as its application of the law to them, has fully presented the facts, and I do not think that his conclusions upon them have been challenged by Mr. Topham on this appeal. I shall, therefore, not endeavour to recapitulate the facts, but I shall refer to some of them which may be necessary.

Now the claim against the auditors is put on three grounds, but first I think I must refer, to make my judgment intelligible, to certain features which have been the subject more particularly of discussion in this Court. The balance sheets of the City Equitable Fire Insurance Co. for 1919, 1920 and 1921 were all of them audited by Messrs. Langton & Lepine. They, all of them, bear the proper statement that 'We have obtained all the information and explanations we have required. In our opinion such balance sheet is properly drawn up, so as to exhibit a true and correct view of the state of the company's affairs according to the best of our information and the explanations given us and as shown by the books of the company.' But it is said as against Messrs. Langton & Lepine that they were guilty of a dereliction of their duty as auditors and that if they had fulfilled the duty, the disaster which overtook the company would not have occurred or at any rate it would not have been of such magnitude, and some of the losses incurred by the company would have been saved. It is, I think, important to mention one or two of the features in these balance sheets. We have before us a very careful and helpful summary of the errors in the balance sheets presented to us, and it appears that in each of the balance sheets a course was adopted whereby it was made to appear that there were a larger number of investments of British Government securities than in fact was the case. It is also said that a larger amount was represented as being loans at call or short notice than was the fact, and that instead of securities being available in the hands of the company itself or of its bankers, some of them were in the hands of Ellis & Co., and in fact had been pledged by Ellis & Co., and it is said that if the auditors had been more careful, they would have discovered these discrepancies between the real facts and those which were presented in the balance sheet. Passing to the balance sheet of 1920, it appears that in that there was a sum which was included in the loans at call or short notice, a sum that was due from Mr. Mansell who was the general manager of the City Equitable Co.—a sum of £52,000—and also a sum of £11,000 due from Ellis & Co. There were also the same features with regard to apparent investments in Government securities which were not truly made, and there was a considerable and increased sum due from Ellis & Co. The last balance sheet differs in one matter from the other balance sheet of 1921, because instead of loans being described as 'at call or short notice' they are described as 'loans' only. It appears that the loan to Mansell which had grown from over £6,000 in 1919 to £52,000 in 1920 had reached a figure of £96,000 in 1921. The sum due from Ellis & Co. in 1921 was over £73,000, but was included in 'Cash at bank or in hand', and there was a very much larger representation of investment in Government securities contrary to the fact.

Now when one approaches this case, quite apart from the question of law which I shall have to deal with, it is of the first importance to remember that we are looking into facts which have been subjected to the scrutiny and have been explained by the ability of accountants who have come in to look at all the books, and not only the books of the City Equitable Co. but the books of Messrs. Ellis & Co. It is not easy to reconstruct the true position as it stood before the auditors when they were called upon to do their duty in the three successive years in which their conduct is challenged. It is also proper to remember that when a big disaster has occurred, such as the failure of this company, which, as I have said, was a notable company in its day, there is, on the part of some, a desire to find some scapegoat who can be found to be responsible and possibly to

make good some of the losses which have occasioned disaster to so many. But it is the duty of the Court, as far as possible, to think about and see what was the problem presented to the auditors and what was the knowledge that was available to them at the time.

Now it is right, and this is fully recorded in Mr. Justice Romer's judgment, to say that the audit in these three successive years, which was carried out by Mr. Lepine, the partner entrusted with it, was carried out with diligence and care. It took something like from six to eight weeks and in a passage in the judgment of Mr. Justice Romer he gives a striking testimony from the evidence, to which he adds his own authority, to show that he was quite satisfied that Mr. Lepine had been both diligent and discriminating and had endeavoured to bring the very best of his abilities to bear on the problem before him. Mr. Justice Romer cites, and I think rightly, a passage from the evidence of Mr. van de Linde, who testified to the care and accuracy displayed by Mr. Lepine in the audit, and he sets out the actual passage in his judgment. Mr. van de Linde says this: 'As far as the figures are concerned, I think there is great accuracy right through,' and then he says this, 'in fact, throughout, always putting aside these matters we have to address ourselves to, speaking generally, throughout, the greatest care was shown and accuracy achieved? (A) Yes.' The learned judge at the close of his judgment says that he is convinced 'that throughout the audits Mr. Lepine conducted, he honestly and carefully discharged what he conceived to be the whole of his duty to the company'.

Now that judgment of the learned judge was delivered after he had had an opportunity of hearing a great number of cases, a good number of addresses from counsel and after he had spent many days in the hearing and trial of the case. I would like, myself, to add that upon the facts presented to us, it appears that Mr. Lepine did discover and asked for explanations which do him credit, for it must be remembered that he had to overcome—if he was to succeed in the task which it is now suggested he ought to have succeeded in—the cunning of a dishonest chairman, and he had to circumvent the ingenuity of the general manager, who was concerned at the same time in obtaining for himself an agreement which I should describe on its face as a fraudulent agreement. Mr. Lepine had therefore a task set before him which must be a difficult one at any time, but a task which, if he failed in it, would only have been recorded of him that he failed to do what would have been a very signal achievement if he had succeeded, because we are to remember not only what was the position of the City Equitable Co., its directors and its chairman, but the position of Ellis & Co. Ellis & Co., of which the chairman, Mr. Gerard Lee Bevan, was the senior partner, was a firm of stockbrokers of good standing and large business upon the Stock Exchange in London. Mr. Bevan was a man credited with very great ability and of high standing as a financier.

Now Mr. Lepine did discover in the course of his inquiries three points which I desire to mention. With regard to the loan to Mansell he pointed out in 1920 that it had reached a figure of £52,000, whereas the only minute that he could find relating to it authorised a sum of £15,000 and not more to be advanced to Mr. Mansell. He made inquiries and he received the answer (I think I am right) from Mr. Bevan himself that a minute would be duly recorded authorising the loan up to the amount at which it stood, namely, £52,000. It appeared to be all right to Mr. Lepine from this fact, that all the cheques by which the loan had been made, and some slips attached to them, if I read the evidence rightly, bore the signature of directors, so that it was not a case in which the manager appeared to be helping himself to money of the company, but a case in which the directors for reasons good and sufficient to them were placing in the manager's hands, for some purpose which Mr. Lepine may or may not have appreciated, sums which totalled up to £52,000. But Mr. Lepine did discover the discrepancy between the amount of the authorised loan and the amount of the actual loan, and he required and was promised that the matter should be regularised in due course by a minute.

Again in 1920 he discovered a matter which he also desired to put right. There was an investment in which the City Equitable were concerned in some ranch in Brazil and payments were made, apparently through Ellis & Co., for the development of that ranch, but it appeared that in the course of 1920 or at the

time the balance sheet of 1920 was produced a sum of £161,000 had been paid through Ellis & Co. to the account or for the purposes of the development of the ranch, and Mr. Lepine discovered that the actual amount authorised according to the minute was £150,000 and no more. We are told that Ellis & Co. in some way or the partners of Ellis & Co. or Mr. Bevan or at any rate one of what I may call the group of persons concerned, who would be in touch with Mr. Lepine, were also interested in this adventure. When Mr. Lepine called attention to the fact that £161,000 had been sent or dispatched or placed in Ellis & Co.'s hands for the purpose of the ranch, and he pointed out that it exceeded the authorised amount by £11,000, he was then told either by Mr. Mansell or by Mr. Bevan that under the circumstances Ellis & Co. would debit it to their account. I suppose in business that meant this, that it was not a matter of very great concern, if all had gone well, whether the money was advanced to the ranch by Ellis & Co. or a partner in Ellis & Co. or one of the persons concerned in it. The sum of £11,000 was comparatively not very large, and whether it was debited to one account or another was a matter of little moment. As a matter of fact in consequence of the information Mr. Lepine received, it was debited to Ellis & Co. and at that time I think there is no doubt from the evidence that Ellis & Co. could have drawn or certainly were supposed to be able to draw a cheque at any time for £11,000 and that £11,000 is found included in the sums at call or short notice. But it is due to Mr. Lepine to say that his diligence did bring him to discover what at any rate was not presented to him in a light which was easy to discover and which must have required some accuracy or persistence on his part, first of all to discover, and then to put right.

Then I was going to mention another matter. There were these so-called 'window-dressing' schemes, and here I think one has to be very careful because at the end of each year the auditor would discover what had happened down to the 28th February, the date at which the accounts close, but he would not necessarily know what had happened in the subsequent year during which he was making up the balance sheet or rather making the audit. It is true that if you take the three balance sheets together and cast them in the form of a chart, you can see that an increasing amount of window dressing was going on, and on the chart you will find that there is a rise of the figures which are manipulated for the purpose of window dressing, and therefore it is easy to read a danger signal from such a chart. No such chart was available to Mr. Lepine and we have to take the books singly which were before him and the books, be it remembered, of the City Equitable only. Therefore it is not right to treat the evidence which is now before us and its significance as being plain in the years 1919, 1920 and 1921 as available to Mr. Lepine. Now I, for my part, desire to accept in whole and in part the admirable summary which the learned judge has given of the facts. I have only referred to those two or three outstanding features for a purpose which a subsequent part of my judgment will show to be necessary, but I have referred to those because they are the salient points in charges which are now made against the auditors.

Now the claim is brought in accordance with the procedure which is rendered available by Section 215, and as an argument was presented to us for which some foundation could be given in substance based upon Section 215, I desire to say, though it is not to be said for the first time, that that Section 251 deals with procedure and does not give any new remedy. It gives no new rights; it provides a summary mode of enforcing existing rights, and I think that is abundantly shown in *Coventry & Dixon's* case (reported in 14 Ch.D. 660) and in *The Brazilian Rubber Plantations & Estates Ltd.* (reported in [1911] 1 Ch.D. 425) and in *Bentinck v. Fenn* (reported in (1887) 12 App. Cas. 652). In *Bentinck v. Fenn* Lord Macnaghten gives in a sentence or so, as he so often does, a really sufficient summary, the other cases being true illustrations of the principle which he enunciates. He says this: 'The section creates no new offence, and it gives no new rights, but only provides a summary and efficient remedy in respect of rights which apart from that section might have been vindicated either at law or in equity.' Then he goes on: 'It has also been settled that the misfeasance spoken of in that section is not misfeasance in the abstract, but misfeasance in the nature of a breach of trust resulting in a loss to the company.' I will not refer to the other cases, but *Coventry & Dixon's* case, *The Brazilian Rubber Plantations & Estates Ltd.* case and *The Jubilee Cotton*

Mills case (reported in [1923] 1 Ch.D. 1) are illustrations which affirm that Section 215 is a procedure section. It is also true that the shareholders of the company are entitled to the protection which is given to them by statute. Mr. Topham tried to suggest, if I properly understood him, that some protection is to be found in Section 215 which I have already dealt with, and that for the purposes of the article, which I shall have to deal with in a moment, protection which is given by statute cannot be overcome by an article. There is no doubt shareholders are entitled to protection, and illustrations of the protection to which they are entitled may be found in the case which was cited to us of the *Peveril Gold Mines Ltd.* (reported in [1898] 1 Ch.D. 122) and in the case of *Payne v. The Cork Co.* (reported in [1900] 1 Ch.D. 308) and in *Newton v. The Birmingham Small Arms Co.* (reported in [1906] 2 Ch.D. 378). Taking that last case, which I want to say a word or two about, it was there attempted by means of an article to prevent a disclosure being made of a reserve fund into which a portion of the property of the company was placed and it was held that it could not be done by the resolutions or by articles because any such resolution or article would be inconsistent with the obligations imposed upon the auditors by the then Section 23 of the Companies Act. No doubt, therefore, we may take it as in these cases and in a number of other illustrations that the shareholders do receive and are entitled to receive the protection given to them by statute in the particular case and by the particular section which has been illustrated or referred to in those cases.

I come therefore to consider what is the protection in relation to the auditors which is given by the statute and that is to be found in the present section, Section 113, subsection 2. By that section it is provided that 'The auditors shall make a report to the shareholders on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office, and the report shall state (a) whether or not they have obtained all the information and explanations they have required; and (b) whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.' Now in terms the balance sheets of the three successive years I have referred to in form complied with that section. All the balance sheets bear the usual statement made by the auditors, so that *prima facie* the auditors have discharged their duty. Then it is said that these auditors have failed and particularly failed in their duty in respect of three matters charged against them. Those three matters are set out by the learned judge on page 1158. They are: '1. Their misdescriptions in the balance sheets of the debts of Ellis & Co. and Mansell by including them under "Loans at call or short notice" or "Loans" or in the case of part of Ellis & Co.'s debt under the heading of "Cash at bank and in hand" and their consequent failure to disclose to the shareholders the existence of those debts. 2. Their failure to detect the fact that much larger sums were in the hands of Ellis & Co. at the date of each of the balance sheets than were so included. 3. Their failure to detect and report to the shareholders the fact that a number of the company's securities, which were in the custody of Ellis & Co., were being pledged by that firm to its customers.'

Now what is the standard of duty which is to be applied to the auditors? That is to be found and sufficiently to be found I think in the *Kingston Cotton Mills* case, which is reported in [1896] 2 Ch.D. 179. From what I have already said it is quite easy to charge a person after the event and say, 'How stupid you were not to have discovered something which if you had discovered would have saved us and many others from many sorrows.' But it has been well said that an auditor is not bound to be a detective or to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, not a bloodhound. That metaphor was used by Lord Justice Lopes in the *Kingston Cotton Mills* case ([1896] 2 Ch. 288). Perhaps, casting metaphor aside, it is more happily expressed in the phrase used by my brother Lord Justice Sargant, who said that the duty of an auditor is verification and not detection. The *Kingston Cotton Mills* case is important because a good deal of sanction is given to those rather epigrammatic phrases. Lord Justice Lindley says this: 'It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to anyone before suspicion was

aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential.' Lord Justice Lopes' judgment, as well as Lord Justice Kay's, may be looked at for support of the words of Lord Justice Lindley, and also in support of what I have called the more epigrammatic way of putting the auditor's duty.

Now let us apply that to the present case. Mr. Lepine went in and spent six or eight weeks with his clerks upon these books. In many ramifications of the business of the City Equitable he finds on the whole all the entries are properly made, and all the accounts are in order. He finds in particular that a larger sum has been lent to Mr. Mansell than was authorised, but he finds that apparently it was the practice of the directors to pay cheques to him. He finds that the amounts of the cheques which were drawn in his favour were entered up. It is not a case in which the cheques had been drawn and not entered and found in the books in which they ought to have been found, but the sum unauthorised, though it was all there in the books, and he turns for guidance and advice to those persons from whom he is entitled to receive guidance and advice. He turns to the chairman, whose position at that time I have described, and he turns to Mr. Mansell, who is obviously a man of commanding position, and on all occasions he gets from them satisfactory answers or satisfactory promises and then one applies this test at a time when no suspicion of anything wrong was entertained, was there a want of reasonable care on the part of the auditors in relying on facts given by competent and trusted experts relating to matters in which information from such persons was essential. I think you can put it interrogatively in this way: Who could be trusted, who could give the information, where would you seek for it more authoritatively than from Mr. Bevan and Mr. Mansell. It seems to me, therefore, that when you apply the test of the standard of care to be exercised you find that in the course of the audit Mr. Lepine has *prima facie* applied or conformed to the right standard as laid down by the Court of Appeal, and a standard which on the facts Mr. Justice Romer says that he did conform to. His diligence is undoubted, and for my part, as I have said, I think that in estimating whether or not you ought to give weight to what Mr. Lepine in fact did discover as indicating that he was on the path to discover, if he possibly could, anything that was awry, and that so far from doing either by negligence or by carelessness or by not caring how the thing was done, simply trusting wholly to the books, and to Mr. Mansell and to Mr. Bevan, you do find in the cases where he was successful in detecting something that was awry, illustration of his diligence and determination to discover what was discoverable.

Now dealing, therefore, with the first two claims, that is the claim in respect of the loans at call or short notice, he had, it seems to me, information which would justify him in putting down those items as loans, and I agree with the learned judge, that putting in the words 'at call or short notice' really was not misleading, and did not cause any wrong result. The learned judge says this: 'If the description of them in the balance sheet as "Loans" would have induced any director or shareholder to make some inquiry as to their nature, which he was induced to refrain from making by reason of their description as "Loans at call or short notice", the matter would be different. But not only is this inherently improbable, there is actual evidence that it was not so.' Then he points out that there was a variation between 'loans at call or short notice' and 'loans', and that Mr. Milligan's attention was attracted to it, and he made some inquiries about it upon which some plausible explanation was received from Mr. Bevan merely on the point as to why the loans were so large, not as to what their character was, and whether they were at call or short notice, because, be it remembered, at that time the company itself was in good credit, and I do not suppose that the idea that they would be ever pressed or be in any difficulty if they required money, and had to turn outside their own circle for it, would have created any difficulty at all in the minds of those who either were directors or constantly dealing with them. It seems to me, therefore, that the learned judge is quite right in the way he deals with the first claim. Then I come to the second. 'Their failure to detect the fact that much larger sums were in the hands of Ellis & Co. at the date of the balance sheet than were so included.' I will come to the question of the signed

certificates in a moment, but the mere fact that Ellis & Co. at that time owed £73,000, or that they put down £11,000 to Ellis & Co., does not seem to me to indicate a danger signal at all. So far as any answers were to be received, or likely to be received, they would be favourable both to Ellis & Co. and to the City Equitable Co., but where you have an atmosphere of complete confidence, indeed of a confidence based on success up to that time in financial matters, it seems to me that there was no reason to hesitate about accepting the view which the company at that time presented to them in their draft balance sheet, that this was a way and a legitimate way of dealing with the over-plus of money due on the Brazilian ranch account, or money due at that time from Ellis & Co., and the fact that Mr. Lepine was unsuccessful in detecting the cunning is quite another matter from saying that he failed to use competence and intelligence in conducting his duties.

Now I come to the last point, part of which is contained in the third charge, and that is the failure to detect the fact that much larger sums were in the hands of Ellis & Co. at the date of the balance sheet, and the failure to detect and report that the securities were in the hands of Ellis & Co. Now upon that matter I want to say a word or two about the evidence. In fact Mr. Lepine inquired from the bank and got a certificate from the bank that a certain number of securities were there, and then he turned to Ellis & Co. and he got from Ellis & Co. under the signature of Ellis & Co. a certificate attached to the document, apparently not by Mr. Bevan but by one of the partners, a certificate that a number of securities were in the hands of the stockbrokers. It is said it was quite wrong to accept the certificate of the brokers, and we are asked to accept the evidence of Mr. Cash and Mr. van de Linde as meaning this, that you may accept the certificate of a bank apparently in all cases but you may never accept the certificate of stockbrokers. I cannot agree that the evidence is so to be read, or is intended by the witnesses to be so understood. **What I think the witnesses meant to express was this: Banks in ordinary course do hold certificates of securities for their customers; it is part of their business, and therefore certificates in the hands of bankers are in their proper custody, and if then a bank is a reputable bank, a bank which holds a high position, you may legitimately accept the certificate of that bank because it is a business institution in whose custody you would expect both to find and put securities, and also it is respectable, but the fact that it calls itself a bank does not seem to me to conclude the matter either one way or the other.** On the other hand, it may be said that it is the duty of an auditor not to take a certificate as to possession of securities unless from a person who is not only respectable—I should prefer to use the word 'trustworthy'—and also of that class of persons who in the ordinary course of their business do keep securities for their customers, and it may be said that a broker does not in the ordinary course of business keep securities for his customers, and therefore he is ruled out because the auditor ought not to accept from a person of that class, whether he be respectable or not, a certificate that he has got securities in his hands. **Now accepting the rule as stated, that it is right to find the securities in the hands of the bank whose business it is to hold securities and applying the proviso that that bank must be one that is trustworthy, it seems to me that that rule may be a right rule to follow, and I think it is prima facie, but it is going too far to say that under no circumstances may you be satisfied with securities in the hands of a stockbroker, because it seems to me in the ordinary course of business you must from time to time, and you legitimately may, place in the hands of stockbrokers securities for the purpose of their dealing with them in the course of their business.** With a large institution like the City Equitable Co., with a very considerable amount of investments to make, and investments to sell, it may well be that for the purpose of the convenience of all parties it may have been a useful method of business even if it had been examined with the most exigent care, for the directors to decide that they would in the interests of their business leave securities of a considerable amount in the hands of their stockbrokers, who, I suppose, at that time held a position not less trustworthy or respected than the City Equitable itself. I therefore do not wish in any way by anything that I say to discharge the auditors from their duties as laid down in the *Kingston Cotton Mills* case, far less do I wish to discharge them

from their duty of seeing that securities are held and only accept the certificate that they are so held from a respectable, trustworthy and responsible person, be that person the bank or be it somebody else, but in applying my mind to the facts of this case I am not content to say that simply because a certificate was accepted otherwise than from a bank therefore there was necessarily so grave a dereliction of duty as to make Messrs. Langton & Lepine responsible. I think in the light of the evidence which has been given it is for the auditor to use his discretion and his judgment, and his discrimination as to who he shall trust, indeed I think that is the right way, to put a greater responsibility on the auditors.

If you merely discharge him by saying he accepted the certificate of a bank because it was a bank you might lighten his responsibility. I think he must take a certificate from a person who is in the habit of dealing with, and holding securities, and who he, on reasonable grounds, rightly believes to be, in the exercise of the best judgment, a trustworthy person to give such a certificate. Therefore I by no means derogate from the responsibility of the auditor, I rather throw a greater burden upon him, but, at the same time, I throw a burden upon him in respect of which the test of common sense can be applied, and common business habits can be applied, rather than a rigid rule which is not based on any principle either of business or common sense.

Then we come to the responsibility which the learned judge finds, and I think rightly finds, falls upon Mr. Lepine. Now, what is that? He finds that in respect of these securities Mr. Lepine did what he ought not to have done by accepting from Ellis & Co. a statement of the securities which they, at that time, declared that they held. The learned judge says this: 'In my judgment, not only did Mr. Lepine commit a breach of his duty in accepting, as he did, from time to time the certificate of Ellis & Co. that they held large blocks of the company's securities, but he also committed a breach of his duty in not either insisting upon those securities being put in proper custody, or in reporting the matter to the shareholders.' As I have said, the learned judge also finds that in what he did Mr. Lepine did honestly, in all good faith: 'holding the mistaken belief as to what his duty was'. I agree with the learned judge. It seems to me that Mr. Lepine has made a mistake and a grave mistake. In justification for him it may be said that every artifice was brought into play in order to deceive him, and to maintain the apparent responsibility and trustworthiness of Ellis & Co. But that does not discharge him from having put aside what I described to Mr. Topham as the rule of the road applied with this proviso as to business rules and common sense. Therefore Mr. Lepine would, *prima facie*, be liable in respect of that dereliction of duty. But then we find that article 150* contains important words limiting the responsibility of the officers of the company, including the auditors, who are not to be liable for any 'loss, misfortune, or damage, which may happen in the execution of their respective offices or trusts, or in relation thereto, unless the same shall happen by or through their own wilful neglect or default respectively'. I do not agree with the argument that that article is *ultra vires*. It does not seem to me that it offends at all against Section 113 in the sense that it is a contradiction of it. It seems to me that Section 113 laid no statutory duties upon the auditor, but not laying statutory duties upon the auditor it calls on him to exercise those duties, and the information is to be given according to the best of their information and the explanations given to them as shown in the books of the company. Once you have any duty to be performed according to the information given, and explanations offered, you obviously introduce matters where discretion is to have play, and it seems to me that the article may quite properly be valid in the sense that it is to discharge the auditor from what may be called technical errors, in common parlance, defaults for which he may be held liable in law, but which he may have unconsciously committed. Now what do the words mean? First of all it is to be observed they are in respect of neglects or defaults, and it is not unimportant to observe that those words are not 'acts or omissions', but they are 'neglects and defaults', and the observations that Lord Justice Bramwell made in *Lewis v. The Great Western Railway Co.* ought

* Quoted *supra* in note at end of Mr. Justice Romer's judgment. Section 152 of the Companies Act, 1929 (now Section 205 of the Companies Act, 1948) excluded auditors from the protection of such an article.—ED.

to be borne in mind, where he deals with the case of wilful misconduct, calling attention to the fact that it is not wilful conduct, but wilful misconduct. It seems to me here that we have got to deal with a case where there has been neglect or default, and then to see whether or not it is wilful. I come, therefore, to consider the meaning of the word 'wilful'. Now in the case of *Young & Harston's Contract* (31 Ch.D. 175) there is a well-known passage of Lord Justice Bowen's in which he says: 'It generally, as used in Courts of law, implies nothing blameable, but merely that the person of whose action or default the expression is used, is a free agent, and that what has been done arises from the spontaneous action of his will. It amounts to nothing more than this, that he knows what he is doing, and intends to do what he is doing, and is a free agent.' There is a number of other cases to which we have been referred, but in the case of *In re The Mayor of London and Tubbs' Contract* ([1894] 2 Ch.D. 524) it is to be observed that Lord Justice Lindley, as he then was, says, at page 536: 'I confess that I am more disposed to concur with Lord Bramwell's observations on the term "wilful misconduct" in *Lewis v. Great Western Railway Company*. They are, in my opinion, quite consistent with Lord Bowen's observations in *In re Young & Harston's Contract*, if it be borne in mind that Lord Bowen presupposed knowledge of what was done, and intention to do it, and was not addressing himself to a case of an honest mistake or oversight.' Lord Justice Lopes, at page 538, is dealing with *In re Young & Harston's Contract*, and with *Lewis v. The Great Western Railway Co.*, and he says: 'It is difficult to lay down any general definition of "wilful". The word is relative, and each case must depend on its own particular circumstances'; and he says: 'If the neglect or default in this case arose from the voluntary act of the parties, either awake or asleep with reference to their rights and interests, and did not at all arise from the pressure of external circumstances over which they could have no control, I apprehend that the neglect or default was wilful'—he is there quoting from Vice-Chancellor Shadwell. Then Lord Justice Kay also agrees with the general view which is presented by Lord Justice Lindley. Now Lord Alverstone, in *Forder v. Great Western Railway Co.*, a later case [(1905] 2 K.B. 532), gives a judgment in which he says this—he is dealing with the definition in an Irish case, with which he agrees—'Wilful misconduct in such a special condition means misconduct to which the will is a party as contra-distinguished from accident, and is far beyond any negligence, even gross or culpable negligence, and involves that a person wilfully misconducts himself who knows and appreciates that it is wrong conduct on his part, in the existing circumstances, to do or to fail or omit to do (as the case may be) a particular thing, and yet intentionally does or fails or omits to do it, or persists in the act, failure, or omission regardless of consequences.' For my own part I agree with that definition as laid down by Lord Alverstone, with the addition that he proposes to give to it. It seems to me in close accord with the previous decisions which I have already referred to, and it seems to give a proper meaning to the words which are before us. I then come to consider whether or not, with that meaning of 'wilful', the conduct of Mr. Lepine was wilful so as to render him responsible, or is he relieved by the terms of article 150? Now we find the auditor confronted with a lot of deceit. We find him fulfilling, year by year, his duty in a manner which has certainly received the praise of those who have given evidence about it, and of the learned judge who heard the whole of the facts. We find that on a number of occasions he was successful in putting what was wrong, or attempting to put what was wrong, right, and therefore you find that so far as his will and volition went, he was attempting to do his duty. Under those circumstances, where you find a default which has been made, and you find an error of judgment in accepting as trustworthy what is now proved to be untrustworthy, can you say, within the definition, that he has been guilty of wilful neglect or default? For my part, for the reasons which I have indicated, and upon the evidence to which I have called attention, it seems to me impossible so to characterise Mr. Lepine's conduct. He did not, to my mind, shut his eyes to conduct which he thought needed criticism; what he did was, in common with a great number of other persons, he thought the people he was dealing with were trustworthy, and, as pointed out in the cases cited to us, but which I do not stop to actually quote, it has been pointed out again and again that he is entitled to accept the statements which were made to him by those whom he was entitled to trust when he has no reason, or call, for suspicion. It appears to me that the learned

judge has quite rightly and accurately applied the law to the facts when he says this: 'If in certain matters he fell short of his real duty, it was because, in all good faith, he held a mistaken belief as to what that duty was', and that the auditor conducted the audits honestly and carefully. He made an error of judgment, an error of judgment which might have caused the company or the directors of the company to take a different course, and might have possibly saved some portion of the disaster, but in what he did I cannot find that he was guilty of wilful misconduct, and therefore it appears to me article 150 protects him. In those circumstances it appears to me that the learned judge was right in the judgment that he has given, and that this appeal ought to be dismissed, and dismissed with costs.

Lord Justice WARRINGTON: This is an appeal from an extremely clear, careful and thorough judgment of Mr. Justice Romer, and as I agree with the conclusions at which he arrived, it is unnecessary to deal in detail with many of the features that have been the subject of discussion here, but there is at least one question of general interest and importance on which I think it is desirable in deference to the arguments which have been addressed to us that I should express my own views in as few words as possible, and that question is the construction of article 150, which is an article, to say the least of it, not uncommonly found in articles of association, and its effect, if any, in modifying or otherwise the ordinary legal obligations of an auditor, especially having regard to Section 113 and Section 215 of the Companies Act. The ordinary duties and obligations of an auditor without reference to this or any other special article or special stipulation as to the terms of his employment are stated by Lord Justice Lindley in full in the case of *The London General Bank* (reported in [1895] 2 Ch.D. 166). It is unnecessary to read the whole of that part of his judgment, it is set out in full on page 1159 of the shorthand notes in the present case in the judgment of Mr. Justice Romer, who quotes him, but I think it is perhaps desirable to read a passage from the beginning of his judgment. The Lord Justice says: 'It is no part of an auditor's duty to give advice, either to directors or shareholders, as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that.' Then he proceeds to discuss in what way he is to perform that duty in reference to examining the books of the company and verifying the statements contained therein in order that he may be able to truly certify that which he has to certify under the Companies Acts. Then he goes on to point out that he is not an insurer, that he is not bound to do more than exercise reasonable care and skill in making inquiries and investigations, and further that what is reasonable care in any particular case must depend upon the circumstances of that case.

Then again, in the case of the *Kingston Cotton Mills Co.*, Lord Justice Lindley, dealing with one particular point that arose in that case, says: 'It was further pointed out that what in any particular case is a reasonable amount of care and skill depends on the circumstances of that case; that if there is nothing which ought to excite suspicion, less care may be properly considered reasonable than could be so considered if suspicion was or ought to have been aroused. These are the general principles which have to be applied to cases of this description. I protest, however, against the notion that an auditor is bound to be suspicious as distinguished from reasonably careful.' So that in that case it was held that the auditor was entitled to accept the certificate of the company's manager though on subsequent investigation it turned out that the manager had been for some years defrauding the company and that his certificate was intended to cover up those frauds. The duty of the auditor is to verify the facts which it is proposed to state in the balance sheet and to verify them, using ordinary and reasonable care and skill. I need say no more about the general duties of an auditor.

The next question is to consider what is the true construction of article 150 and how that article bears upon or modifies those which would be in the ordinary course his *prima facie* duty and responsibilities—not so much the duty but the responsibilities of the auditor. [The lord justice went on to consider the effect of article

150, but inasmuch as auditors are now, by the Companies Act, 1929, deprived of the protection of such an article this portion of the judgment is not quoted.]

The lord justice continued: Now, that being the true construction, and the actual effect of article 150, was there anything which the auditors in the present case either did, or omitted to do, which was such an act or omission, wilful default, or neglect, on their part? I do not propose to go through the evidence in this case on that point. I think it is enough for me to read what Mr. Justice Romer says, and to say that I thoroughly agree with his conclusions. He says: 'I have heard Mr. Lepine's evidence in the witness box, and I have inspected many of the numerous documents prepared by him for the purposes of the audits that he conducted. I am convinced that throughout the audits that he conducted he honestly and carefully discharged what he conceived to be the whole of his duty to the company. If in certain matters he fell short of his real duty it was because, in all good faith, he held a mistaken belief as to what that duty was.' It seems to me that, agreeing with that view, I must agree with the conclusion at which Mr. Justice Romer has arrived, that the application of the Official Receiver against the auditors fails.

Now I only want to add this. Mr. Justice Romer came to the conclusion that, but for article 150, he would have held, and did hold, that there was negligence on the part of the auditors in regard to the inspection of the securities which were, in fact, in the possession, or ought to have been in the possession, of Ellis & Co., and as to which that firm gave a certificate which was accepted by the auditors. With regard to that, I only say this: We have not heard Mr. Stuart Bevan on that point, and it is at least arguable, I will not say more than that it is arguable, that in the particular circumstances of the present case there was not, in fact, negligence on the part of the auditors, even without reference to article 150. I do not say that I differ from Mr. Justice Romer, I only think that it is fair to Mr. Lepine to say that not having heard Mr. Stuart Bevan on that point, the matter is one which is at least worthy of argument.

On the whole, therefore, I agree that the appeal must be dismissed with costs.

Lord Justice SARGANT: I would examine the questions here in a different way from that in which they were presented to us. I will take first the question whether the terms of article 150 are effective to limit or restrict the extent of the *prima facie* liability of the auditors. [For reasons given above the passage bearing on this point has been omitted.]

As to the facts it seems to me there is little, if any, dispute. They have been most carefully and exhaustively stated by Mr. Justice Romer in his admirable judgment, and it is unnecessary to recapitulate them. But there are two considerations on which special stress should be laid. The first is the very great care exercised by Mr. Lepine in the performance of his duties, a circumstance to which marked attention is shown in the judgment of the learned judge. There was obviously on the part of the auditors an honest and diligent performance of their duties to the best of their ability, and that is a fact of the utmost importance. The second is this, that in this particular case Mr. Lepine was in fact dealing with a most unusual state of things, a combination in Mr. Bevan of exceptional ability, exceptional reputation and quite exceptional roguery. Mr. Bevan had succeeded in deceiving not only all the other directors of the company, but all his numerous partners in the firm of Ellis & Co., and he was compelled on behalf of Ellis & Co. to cause corroboration to be given to statements made by the company, independent corroboration by innocent persons, his own partners, although those persons had in fact derived their information from Mr. Bevan himself. Now Mr. Bennett in his concise argument, none the less meritorious because of its conciseness, suggested that the statement in the balance sheet made a gradual and increasing divergence from the truth, and in so doing was inspired by someone in the background who was trying more and more to conceal the real state of things. I suppose he meant by Mr. Bevan, or possibly by Mr. Mansell. But I think that this circumstance is rather in favour of the auditors than against them. If these statements had been made on the initiative of the auditors themselves there might have been some ground for some suspicion, but when what they do is to adopt the phraseology of a rogue and fail to detect the implications arising from that phraseology it seems to me that the circumstance that that is all they are doing is one very definitely in their favour.

Now the heads under which the auditors were sought to be rendered liable are summarised very clearly by Mr. Justice Romer in that part of the judgment which is to be found at page 1158 of the record. As regards the first two heads I do not propose to say anything. I only deal with the last head, namely, that connected with the leaving of the securities in the custody of the brokers. In the first place I think that the strict rules as to trustees do not necessarily apply to limited companies in all their regard. Trustees are dealing with other people's property. Limited companies are dealing with their own funds. It may well be that certain companies may find it advantageous to allow brokers or agents to hold or to have free access to securities which trustees are not entitled to do. That is a matter, it seems to me, for the internal regulation of a company, having regard to the character of its business. Speaking generally, I should have thought it was inadvisable to leave marketable securities with brokers or other persons not accustomed like bankers or safe deposit companies, to hold and keep securities as part of their ordinary business, and in any ordinary case I think it would be desirable that auditors should call attention to and require some justification for a practice of this kind. But the matter seems to me to be essentially one of degree, and one which is not regulated by the definite strict rules which govern the conduct of trustees in such matters. In the next place I want to say this, that in my judgment it would not be right that auditors should deliberately adopt a standard of verification less than the ordinary, below the ordinary standard, because the persons with whom they are dealing are persons of specially high reputation. It would be dangerous to adopt any such lower standard on account of that circumstance. But I cannot find that the auditors here did deliberately adopt any lower standard of that kind. Mr. Lepine was, in my view, adopting the standard which he thought was the proper standard, and one that was not definitely below any standard to which he was accustomed in ordinary transactions. Here I wish to express my opinion, that undue stress was laid by the appellants on the effect of the evidence of Mr. van de Linde and Mr. Cash. Counsel seemed to treat the practice of those persons as if it had been embodied in a written or printed code. I think that is to treat the matter altogether too rigidly, and even taking the practice of Mr. van de Linde and Mr. Cash as they stated it before the Court, there was a considerable borderline of undefined territory in which the auditor had to be guided by his own personal view of what was sufficient in all the circumstances of the case. In my judgment, therefore, it is impossible to treat Mr. Lepine as having definitely gone contrary to a well defined or well recognised practice such as could only have been justified in most exceptional circumstances.

Now, I desire to add this, a matter to which Lord Justice Warrington has referred, I do not wish to definitely say that I agree with the view that has been given by Mr. Justice Romer, that apart from article 150 the auditors would have been liable. We have not heard on that point any argument on behalf of the auditors, and I can quite see that there might be an argument of considerable force which might be addressed to us to prevent our holding that they were neglectful or were in default apart from the special provisions of that article. But having regard to the provisions of that article, and having come to the conclusion, as I have, that the very most that can be said against Mr. Lepine is that he committed an honest error of judgment, I am clearly of opinion that he is protected, even if he were otherwise liable, by the special and concluding words of article 150.

THE MASTER OF THE ROLLS: The appeal is dismissed with costs.

STAPLEY v. READ BROTHERS LTD.*

(Decided by RUSSELL, J., in the Chancery Division, on 17th March, 1924)

Held that a company that has written down its assets excessively out of profits may subsequently write them up again to the extent of such excess and apply the amount thereof in payment of dividends.

This was a motion for an injunction to restrain the defendant company: (1) from distributing in dividend the credit balance of the profit and loss account at 31st

* [1924] 2 Ch. 1; LXVIII, *The Accountant* L.R. 111.

December, 1923, or any part thereof, until the debit balance on the profit and loss account at 31st December, 1922, had been discharged; and (2) from treating as profits available for dividend (a) any profits originally applied in writing off or down the book value of any of the assets, and subsequently written back on the ground that such assets stood in the company's books at less than their true value; (b) any unrealised profit arising from an estimated increase in the value of any capital asset.

Until 1906 the balance sheets of the company contained an item of £140,000 for goodwill. Between 1906 and 1917 various amounts were written off out of profits, and in 1917 the goodwill had been written down to £51,000. In the meantime a reserve fund of £61,000 had been built up out of profits, and in 1917 the goodwill account was eliminated from the balance sheet by writing it off against the reserve fund, which was thus reduced to £10,000, the goodwill disappearing altogether from the assets side of the balance sheet. In 1920 the reserve fund amounted to £25,000, and there was also a sum of £33,000 balance of profits brought forward from the previous year. The company then capitalised the reserve fund and £15,000 of the balance of profits by issuing 40,000 £1 bonus ordinary shares. In the two following years the company made a loss of £20,000, and the debit balance of profit and loss account at 31st December, 1922, was £20,504. In 1923 the company made a profit of £13,000. The preference dividends for 1921, 1922 and 1923 were unpaid, and the directors, in their report for 1923, first pointed out that a sum of £180,000 which might have been distributed in dividends had been retained in the business by writing off the sum of £140,000 at which the goodwill had stood originally in the balance sheet, and by the issue in 1920 of 40,000 bonus £1 shares, and then recommended that the three years' arrears of preference dividends up to 31st December, 1923, should be paid out of the current year's profits, and that the debit balance of £20,504 should be carried to a suspense account, and written off against a reserve of £40,000 to be created by writing back to reserve £40,000 out of the profits previously applied in writing off part of the goodwill.

As regards the first part of the motion, Russell, J., pointed out that it in no way depended on the question of restoring the goodwill as an asset in the balance sheet and writing back profits to reserve. The sole question was whether profit and loss was to be treated as a continuous account, so that no dividend could be declared out of one year's profits until any debit to profit and loss in respect of prior years had been made good. His lordship said that this point was covered by the decision in *Ammonia Soda Co. Ltd. v. Chamberland* (1918) 1 Ch. 226, and he therefore refused to grant the injunction.

In dealing with the second part of the motion his lordship said that the point was not covered by direct authority. Had the company retained the goodwill as an asset in the balance sheet, and, instead of writing off its value out of profits, had carried those profits to a goodwill depreciation reserve fund, it could have distributed those profits at any time to the extent by which the amount of the reserve fund exceeded the amount of actual depreciation. It was admitted that the value of the goodwill was at least £40,000 and if therefore there had been £40,000 to the credit of that reserve fund, the company could have distributed £40,000 of that reserve as profits. The question was whether it made any difference that the company, instead of placing its profits to reserve, had purported to apply them in writing off a corresponding amount of the value of the goodwill. The answer to that question depended on whether the company had finally and unreservedly capitalised those profits so as to disentitle itself for ever from restoring them to reserve and treating them as profits. The accounts which showed the particular method adopted had been approved each year by the shareholders at the annual general meetings, but his lordship said that he was not satisfied that the shareholders had thereby intended to bind themselves for all time to give up their claim to those profits, and to treat them as capital only. In his opinion the shareholders might, if they thought fit, write back to the profit account the £40,000 which was admitted to be the amount by which the depreciation written off goodwill exceeded the proper requirements. There was no provision in the Com-

panies (Consolidation) Act, 1908, or in the constitution of the company, to prevent this course, which was furthermore not prejudicial to creditors.

He therefore refused to grant this injunction also. The question raised in (2) (b) of the motion did not fall for decision.

HOALE AND OTHERS v. TINGEY*

(Decided by ROCHE, J., in the King's Bench Division on 25th March, 1926)

Action by accountant for fees—Counterclaim for damages for retention of defendant's books and papers—Accountant's rights to a lien upheld

The facts sufficiently appear from the judgment.

JUDGMENT

Mr. Justice ROCHE: In this case the plaintiffs claim a balance of £250 alleged to be the agreed amount due in respect of the remuneration of the plaintiffs for work done as accountants for and on behalf of the defendant. The defendant's pleaded case is that there was no agreement and that the amount claimed is in excess of a reasonable amount for remuneration. The defendant counterclaims for the return of a sum of £200 as overpaid by him, and also claims certain remedies in respect of the detention of his books and papers by the plaintiff firm.

The facts as I find them are these. The plaintiffs are accountants, and the defendant is a confectioner and tobacconist, and he began business on the premises where he now is in about the year 1909 or 1910. Before the war, and still more during the period of the European war of 1914 and 1918, he was making very large profits in the business, but unfortunately he permitted himself to make wholly false returns in respect of the taxation which was due from him. In the year 1924 he was found out and he called in the plaintiffs as accountants to make up his books, or, rather, to make accounts, because there were no books, so as to represent what he had in fact earned by way of profit in order to satisfy the Inland Revenue authorities, who were apparently dissatisfied with the defendant and were determined that he should pay what was due from him to the Crown. The plaintiffs conducted those investigations. It is unnecessary that I should enumerate what they were, but they investigated them under very difficult circumstances, because obviously the defendant, having been minded to take the course that he was minded to take and had taken, had kept as far as possible all signs of what he had done away from observation. The plaintiffs, I find, through Mr. Smith, the partner of the firm who dealt with this matter, made it plain to the defendant that the matter was far from easy and a difficult one, and that it would involve his personal attention and that he would have to do the main part of the work himself personally for a very good reason: Mr. Smith had to act as both an accountant and as an advocate in this matter, and an advocate with a reputation and with a responsibility, as he had to acquit himself so as to satisfy the Inland Revenue authorities with arguments based on figures which were at once honest and to which he could commit his reputation. Mr. Smith also made it plain to the defendant that up to one stage the work could cost £300, and that he would require £150 on account. That £150 was paid. There was a balance of £150 when that work, which was the preparation of some twelve years' work, was completed. But when that was done and the £300 was paid there was further work which had to be done. The Inland Revenue authorities were not satisfied. They required that the researches should go back still further. Thereupon, or soon after that, at a later stage another sum of £250 was paid, making £550 in all. It is £200 of the last £250 which the defendant is asking that he should recover back from the plaintiffs. When the work was completed so far as the Inland Revenue authorities required it to be completed, and all was ready for the final settlement except the willingness of the defendant to settle, the figures were put before Mr. Tingey, the defendant, and thereupon, according to the plaintiff's case, that is to say in the month of June, 1925, some fifteen months after the first employment of the plaintiffs, the balance due was agreed at the sum of £250. It is that £250 that the plaintiffs seek to recover.

I have arrived at the conclusion upon the evidence that the sum of £250 was

* Reported in *The Accountant*, 3rd April, 1926, p. 518. See also *Trinidad Land & Finance Co. v. Clifford & Clifford, The Accountant*, 1st May, 1926, p. 627.

agreed, and that in one sense makes an end of this case. But it is due both to the counsel who have submitted their contentions very clearly before me and to the plaintiffs themselves that I should say a word about the question of whether those charges were reasonable or not, and it is fitting that I should say so because if the charges were too large it would render the likelihood of an agreement more improbable, and it would also be in a sense a reflection upon the plaintiffs. I have arrived at the conclusion that having regard to all the facts of the case and the difficulties of the situation the amount was about right. It is impossible in the circumstances of this case, having regard to the agreements and payments on account that have been made from time to time, and the work that had to be done by Mr. Smith at home, to view very nicely and measure very exactly pound by pound the proper charges, and I have not purported to do so. I am satisfied, having heard all the evidence, that the amount was, as I have said, about right.

Now as to the conclusive matter in the case, namely, whether there was an agreement, I base my opinion and judgment on three grounds. The first is that having heard the evidence of Mr. Smith and the defendant, Mr. Smith deposing to an agreement, I accept Mr. Smith's evidence, and where it is in conflict with the evidence of the defendant I do not accept the evidence of Mr. Tingey in reply. The second ground is that broadly speaking Mr. Tingey agrees about the essential matter with Mr. Smith, that is to say, he assented to the proposition that he did agree to pay the £250 now claimed, but he set up the contention that he made it on suppositions or terms which have been proved to be either mistaken suppositions or terms which have not been fulfilled. He says, put in brief and practical shape, that he was only to pay when he finally settled matters with the Inland Revenue authorities, and that he was informed by Mr. Smith that he could settle for a comparatively small sum of £200 or £300, and that Mr. Smith supposed no question of penalties would arise or that all questions of penalties would be waived. As to that, there are several difficulties in the defendant's way. First, there is no such matter pleaded in confession and avoidance of the agreement which I have found was arrived at and which Mr. Tingey has said was not. The second and more important ground is, I find that no such conditions were imposed, and that no such supposition could have been indulged in by Mr. Tingey, and Mr. Smith said nothing that could have encouraged the defendant in the belief that he could escape those penalties. The third ground on which I have come to the conclusion that an agreement was arrived at is this, that very shortly after this date, that is to say in July, 1925, the plaintiffs rendered to Mr. Tingey an account of their services which brought out the figure at £840, and credited £550 as paid on account, leaving a balance of £290 but reducing it in a way which is very familiar to an agreed sum—'say £250, as agreed'. That account was received by Mr. Tingey, and I can find no trace of any dissent from the assertion that that £250 had been agreed. It is said that at all events payment was not to be made until the matter with the Inland Revenue authorities had been settled. It is said in substance that the plaintiffs repudiated their part of the bargain to secure a settlement by abandoning the work and giving up the employment. What happened about that was this: Mr. Tingey, thinking he could negotiate better with the Inland Revenue authorities than Mr. Smith could, and disliking his advice in the matter to make an offer to the Inland Revenue authorities, refused to follow his advice, and Mr. Smith, not unnaturally, did not go any further in the matter. As it turned out, Mr. Smith's advice was abundantly sound, because the accountant who took over the work from Mr. Smith, after investigation, advised him to settle for the precise sum which Mr. Smith had suggested he could settle for if he made an offer to the Inland Revenue authorities. Under those circumstances it was not the plaintiffs who in any sense repudiated their bargain; it was Mr. Tingey, who having put the matter into other hands, and having refused to take the advice of his then adviser, rendered that consummation through the plaintiffs impossible. Therefore, quite apart from any question of plea, I pronounce against those contentions raised on behalf of the defendant. That results in a judgment for the plaintiffs for the sum of £250 on the claim.

Now with regard to the books. The plaintiffs claim a lien for their work done upon the books and papers and the matter was dealt with by a sum being paid into Court—a very sensible arrangement. The case to which I referred was the case of *Ex parte Southall; in re Hill* (reported in 12 Jur. at page 576). Although it

is not a decision, but only an intimation of the opinion of Vice-Chancellor Knight-Bruce, it is, I think, a very weighty opinion and in principle it seems to me with regard to the papers and the books upon which the plaintiffs did work and on which they themselves made a considerable number of entries, their rights to a lien existed and the counter-claim must be dismissed.

There will be a judgment for the plaintiffs for £250 on the claim and on the counter-claim with costs.

Mr. Vos: Would your lordship be good enough to make an order for payment out of Court of the £250, and the £20 to be set off against costs?

Mr. Justice Roche: What is the £20?

Mr. Vos: Twenty pounds was paid into Court as well as £250 on account of costs.

Sir Malcolm Macnaghten: It ought to be money in Court to be paid out to the plaintiffs in satisfaction of the judgment and on account of costs.

Mr. Justice Roche: Yes, that will do.

Sir Malcolm Macnaghten: If your lordship pleases.

THE TRUSTEE OF THE PROPERTY OF APFEL (a bankrupt) v.

ANNAN, DEXTER & CO.*

(Decided by ASTBURY, J., in the Chancery Division on 9th November, 1926)

Accountancy and auditing—Action against accountants—Contract of employment—Duties of auditors—Distinction between accountancy and auditing

This was an action brought by Sir Harold Moore, F.C.A., of Messrs. Moore, Stephens & Co., chartered accountants, the trustee of the property of Mrs. Adele Apfel, a bankrupt, against Messrs. Annan, Dexter & Co., chartered accountants, for alleged negligence and breach of contract.

The facts of the case are clearly set forth in the judgment of Astbury, J., which is reported in full:

JUDGMENT

ASTBURY, J.: This is an action to recover £28,601 from the defendants as damages for alleged negligence and breach of duty as accountants and auditors.

The plaintiff is the trustee of the property of Mrs. Adele Apfel, a bankrupt, against whom a receiving order was made in July of last year, followed by an adjudication on the 23rd of the same month. The defendants are a firm of chartered accountants, and carry on their business in London. From the month of May, 1922, down to the commencement of her bankruptcy, Mrs. Apfel carried on business as a skin and fur merchant at 41 Queen Street, London, under the style of A. Apfel. She took no active part in the conduct of the business, but employed her two sons, Edwin and Harry Apfel, as managers at a weekly salary. The statement of claim alleges that the bankrupt employed the defendants: 'for reward to audit the accounts of her business for the period ending 31st December, 1922'—that is for eight months—'and for the twelve months ending the 31st December, 1923'. It is alleged that the audit for the period ending December, 1922, was carried on and completed about June, 1923, on which date what purports to be a balance sheet of the business was signed by the defendants. The audit for the year 1923 is alleged to have been carried on and completed in or about June, 1924, at which date again a balance sheet of the business was signed by the defendants. The plaintiff alleges that during the periods covered by the audit the bankrupt's two sons, who were authorised by the bankrupt, for the purposes of her business, to sign and draw cheques on her banking account, drew from the business and converted to their own use large sums of money which were paid into their private accounts, or otherwise applied for their own purposes. Particulars of this charge are given as follows: During the period ending the 31st December, 1922, Edwin Apfel drew sums amounting to £1,270 odd, and during the twelve months ending December, 1923, further sums amounting to £3,678 odd, making a total of £4,940, after allowing all items to the credit of his account; and that during the period ending December, 1922, Harry Apfel drew from the business sums amounting to £1,026, and during the twelve months ending December, 1923, further sums amounting to £3,658, making a total of £4,684, after allowing

* 70 *The Accountant* L.R. 57.

all items properly credited to his account. That covers the whole of the period during which the defendants were employed.

It is then alleged in the statement of claim that from the 1st of January, 1924, down to the commencement of the bankruptcy the two sons continued to draw from the business, and converted to their own use, further large sums of money. Particulars of those sums are that Edwin Apfel, in 1924, drew £7,580, and in 1925, up to the bankruptcy, £5,284, making in all £12,864; and that Harry during the same periods drew in 1924 £5,724, and in 1925 £2,664, making in all £8,398. In February, 1926, these two sons were tried at the Central Criminal Court on indictments charging Edwin with the fraudulent conversion of a sum of £15,963, and Harry with the fraudulent conversion of £9,583, which sums comprised the moneys hereinbefore referred to. Edwin pleaded guilty and was sentenced to fifteen months' imprisonment. Harry Apfel pleaded not guilty, and the charge against him apparently was not pressed and he was discharged. Harry Apfel has since died and Edwin is undergoing his term of imprisonment.

In June, 1925, the bankrupt executed a deed of assignment to one Bostock, a partner in the defendants' firm, as trustee for the benefit of her creditors. On the 25th June, 1925, a meeting of her creditors took place at which Bostock was present, and a statement of her affairs prepared by the defendants showed a deficiency of £30,537. Included in this deficiency was a sum of £24,533 to the bankrupt for her two sons according to the plaintiff's charge.

The plaintiff then asserts that by reason of the injury to the bankrupt's estate the estate has suffered damage from the negligence or breach of contract of the defendants as auditors and accountants in respect of their audit of the accounts up to the 31st December, 1922, and the 31st December, 1923. Elaborate particulars of that alleged negligence and breach of contract are given. I think it is better to read these particulars as they show the charge which I have to investigate. They are as follows: 'During the conduct of the audits for the periods ending the 31st December, 1922, and the 31st December, 1923, the defendants knew or ought from a proper scrutiny of the books of the business to have known that the sums of money drawn by the said sons were in excess of the amounts they were properly entitled to draw and were in excess of the amounts that the business could stand. The defendants knew, or if the cash payments of the said business had been vouched by them either properly or at all ought to have known, that the said sums had been paid into the private banking accounts of the said sons or had been expended by them for their private purposes and not for the purposes of the business. The defendants knew that the said sons had purported to cover up and conceal the extent of the said drawings by the two book entries crediting to each of the said sons the sum of £1,000 as a bonus on the profits of the business over the period ending the 31st December, 1922, and by two further book entries crediting to each of the said sons the sum of £1,500 as a bonus on the profits of the business over the year ending the 31st December, 1923, and the defendants with full knowledge of the facts sanctioned and passed these entries although as they well knew the business was being run on borrowed capital and had not made profits from which the said or any other bonuses could be paid. None of the said bonuses were disclosed either properly or at all in the profit and loss accounts or balance sheets prepared and passed by the defendants, and the balance of the sons' indebtedness to the bankrupt, after giving credit for the said bonuses, was shown in the balance sheets as an ordinary book debt and taken at its face value, although the defendants knew that the sons were insolvent and impecunious persons or alternatively by making any or proper inquiries could have so ascertained. The defendants, although they knew that the bankrupt was a lady with little or no knowledge of business, depending on the proper exercise by them of their duties as auditors and accountants, never gave to the bankrupt either by letter or by interview or otherwise any or any proper information as to the true position of the business or the conduct of the sons as managers, although the facts were well known to them, and more particularly never disclosed to the bankrupt that the said sons were drawing out cash from the business as hereinbefore alleged, and never disclosed or explained to the bankrupt the nature of the entries relating to the said drawings or the said bonuses but withheld all information and explanation from the bankrupt. The balance sheets and profit and loss accounts prepared and passed by the defendants were misleading so far as they concealed or failed to

disclose the matters hereinbefore alleged and so far as they showed that the business was being properly conducted and was solvent and being carried on at a profit. Neither during the conduct of the 1922 or the 1923 audit did the defendants search the entries in the cash book and ledger of the business in use during the periods when the audits were being conducted, which inspection would have revealed that the said sons or one or other of them were continuing to misappropriate the funds of the said business.' Then it is alleged that the estate of the bankrupt has suffered special damage from the month of June, 1922, to the commencement of the bankruptcy, and the sons, or one of them, during that period, had drawn from the business and converted to their own use sums amounting to £30,898, and after deducting from this sum amounts drawn from the business before the first audit conducted by the defendants a sum of £2,297, there remains a balance of £28,601, which is the amount of damage claimed from the defendants in this action.

The case, as I have referred to it, made against the defendants is one of a particularly grave character. The actual negligence alleged is limited to the defendants' conduct during the eight months of 1922 and the twelve months of 1923 in respect of the two sets of bonuses and the other over-drawings by these two manager sons, and it is by reason of that negligence that the plaintiff claims to recover the sums wrongfully overdrawn by the two sons after the termination of their employment.

No charge of fraud or dishonesty is made against the defendants. Prior to the bankrupt, Mrs. Apfel, commencing to carry on her business in May, 1922, her husband had carried on the business or a similar business, and on his death in or prior to the month of May, 1922, that the business was found to be insolvent with a deficiency of something approaching £200,000, and Mr. Bostock, one of the partners in the defendant firm, was concerned in that matter. A deed of assignment for the benefit of the creditors of the old business was executed by the sons as the surviving partners of their father, they each having had a small interest in their father's business, and ultimately an arrangement was made under which the creditors of the old business agreed to accept a composition of 3s. in the £. Both these sons also were insolvent, and they executed on their own behalf deeds of assignment of their assets to Mr. Bostock for the payment of their private debts, and a composition was accepted by their creditors.

The bankrupt when she commenced her business carried it on in a sense as a continuance of the old business subject to the payment of this composition, it being in law a fresh business of hers, and she borrowed a sum of £8,000, or thereabouts, for the purpose of commencing that business. The private estate of the husband was used, *inter alia*, for the purpose of paying this composition, and it is said that as Mrs. Apfel was the executrix and sole beneficiary under her husband's will that in so far as there were surplus assets ultimately realised of the old business in excess of a sum required to pay the composition of 3s. in the £ that that private estate of Apfel, senior, ought to have been returned to her. By reason of what occurred before the employment of the defendants during the years 1922 and 1923 by Mrs. Apfel, and by reason of what was discovered after their employment ceased, an atmosphere of fraud and suspicion has been introduced into this case, and it is necessary for the purpose of deciding the particular issue raised by the pleadings to disentangle the relevant facts and ascertain first what exactly the defendants were employed to do by Mrs. Apfel during the period of their employment; secondly, what they knew or ought to have known during that period; thirdly, what they brought to the notice of their employer while their employment lasted; and fourthly, what relief, if any, under the relevant circumstances Mrs. Apfel's trustee in bankruptcy is entitled to in this action in her absence, and without the assistance of any evidence from her.

Mr. Bostock and Mr. Lovatt were the two partners in the defendants' firm who were concerned in their employment in question. With regard to the old business, Mr. Apfel, senior, died in April, 1922. As I say, his sons had been his junior partners, Harry being entitled to one-fourth of the profits and Edwin to one-tenth, and shortly prior to Mr. Apfel, senior's, death these three partners had drawn from this business, which was hopelessly insolvent, sums of about £5,000 each. It is, however, only with the business commenced by Mrs. Apfel in May, 1922,

that this action is directly concerned. During the time that she carried on that business, and while the defendants were employed by her, she never personally attended at the place of business for any business purposes. She appointed her two sons to be her managers, and apparently left the whole management of her business in their hands.

The first question which I have to determine as best I can is what was in fact the character of the defendants' employment. There has been a considerable discussion upon this matter. The plaintiff alleges that they were employed as auditors with all the responsibilities attaching to that sort of employment. The defendants, on the other hand, allege that they were only employed as accountants to prepare, on Mr. Apfel's behalf, such accounts as were necessary for the purpose of filling in Mrs. Apfel's income-tax return for the year, or for the period ending December, 1922, and for the year 1923. On the 27th February, 1923, the Inspector of Taxes wrote to Mrs. Apfel: 'I have to request that you will complete and return to me the form recently sent you requiring a return of your income for assessment to income-tax.' That form and that demand were handed to the defendant by one of these sons, and they on the 1st March, 1923, wrote to the Inspector of Taxes: 'Our client has handed us your printed letter of the 27th ultimo asking for a return for assessment. We beg to inform you that we hope to have the accounts prepared within six weeks, and will then report to you as soon as possible.' The defendants were instructed, as appears from this last letter, to prepare the income-tax return of Mrs. Apfel to December, 1922, and later they were instructed on her behalf to prepare a similar income-tax return for the year 1923. These were the only instructions that they ever received from or on behalf of Mrs. Apfel, who must be taken to have been their employer. In order to carry out their instructions the defendants had a considerable amount of work to do on the business books which were badly and insufficiently kept, and at a later date they or their clerks charged Mrs. Apfel with the preparation of accounts and the auditing of her books, and it has been contended, as I have stated, by the plaintiff that they, having regard to this charge, were employed as auditors as well as accountants. **As I understand the contention, it is said, and I think truly, that an auditor who is instructed to make a full audit of business books is responsible not only for getting out such accounts as the books when properly made up appear to show, but they are also responsible for ascertaining the true position of the business, whether disclosed properly by the books or not.**

The defendant's contention is that they were only employed, notwithstanding these charges, as accountants to prepare these income-tax returns, and to do what was necessary to the books for that purpose; and it is contended by them, and again I think rightly, that if that was the character, and the only character of their employment, they were not responsible for the entries in the books, as to their correctness or otherwise, but were only responsible for ascertaining from the books when made up to the best of their ability the position of the business as so shown.

Now there are two forms of certificates that professional men in the position of the defendants are in the habit of giving. One is an audit certificate stating that the accounts to which they put their hands reflect the true position of the business dealt with in the books. The second is a certificate that, treating the books as made up for what they are worth, the accounts prepared reflect, and only reflect, the position of the business as shown in the books. I have heard Mr. Bostock and Mr. Lovatt, the two partners concerned, in the witness box, and one of their principal clerks who was employed to make up these books, in so far as they required making up, and I am satisfied from their evidence that, notwithstanding the form of charge which was sent in, the defendants, that is Mr. Bostock and Mr. Lovatt, believed that they were doing accountancy work only in pursuance of the only instructions which they ever received. I shall come back to that presently.

I have dealt with the inception of the defendants' employment, and I will now discuss what they actually did in that employment during these two periods. Having made up, with the assistance of their clerks, Mrs. Apfel's books in order to enable them to prepare a profit and loss account and balance sheet of the business for submission to the Inspector of Taxes, the defendants got out a profit

and loss account and balance sheet of this business for the period of eight months ending December, 1922. Those accounts were signed on the 19th of June, 1923, and the certificate given by the defendants on those accounts is as follows: 'Prepared from the books of Mrs. Adele Apfel, and in accordance therewith.' Now that is certainly not in any sense the ordinary certificate of an auditor, but it is the form of certificate which, if they had been employed, and only been employed, to get out her income-tax return, one would have expected.

Now in the profit and loss account for the first eight months, which is all I am dealing with at the moment, the defendants have put down as wages a sum of £3,269. That includes two sums of £1,000 drawn by each of the sons out of the business during that period by way of bonus, and being drawn by way of bonus, and apparently being a contribution made to them by their employer out of the business, it was an inaccurate, and, in other circumstances, might have been an improper method of describing the so-called wages paid by this lady. What she really did pay during that period as wages was a sum of £1,269, and not £3,269, £2,000 of it having been a payment taken by, or given to, these two sons by way of bonus out of profits. The balance sheet shows a profit for the eight months ending December, 1922, of £2,830, less drawings (those are the drawings by Mrs. Apfel of £907), leaving what is shown as a balance of £1,923. On the assets side of the balance sheet appears an entry: 'Sundry debtors and debit balances £4,460'. During this period of eight months the sons drew out of this business, almost day by day, considerable sums amounting, in the case of Edwin Apfel, to £1,791, and in the case of Harry Apfel to £1,809. After crediting the two sons with certain credit items appearing in the books, and, for all I know, properly appearing in the books, Edwin had drawn out of this business during the eight months a net sum of £1,270, and Harry a net sum of £1,026. As I have said, £1,000 to each son was treated, in the circumstances that I have mentioned, as a bonus payable to them by their mother. That leaves £270 of overdrawings by Edwin and £26 of overdrawings by Harry, and those two sums of overdrawings are, in the balance sheet, included under the heading: 'Sundry debtors and debit balances'.

It has been proved during the hearing, which I think was unknown to the plaintiff when he commenced this litigation, that the whole of the drawings of these two sons during the first eight months were obtained by cheques signed by Mrs. Apfel herself. This old lady, who did not attend at the business premises, was in the habit of signing cheques, no doubt at the instance of her sons, sometimes I believe filled up before she signed them, and, in other cases, signed in blank, but as a matter of fact, every penny that these sons drew out of this business during the first eight months was drawn by means of these cheques signed by their mother.

When the defendants were about to prepare a profit and loss account and balance sheet for this first period they, of course, ascertained these large drawings, and they asked the sons for an explanation. They were told by the sons that their mother had agreed that they should have a bonus out of this business, either in principle or as to a definite sum, and the defendants properly said that they could not sign these accounts unless this bonus matter was cleared up, and they asked the sons to obtain from their mother information as to whether she has assented to these bonus drawings. In pursuance of that request, two letters were obtained by the sons and handed to the defendants, each dated the 31st December, 1922. They are in a stilted form when one considers that they are addressed by a mother to her sons, and read as follows: '41 Queen Street'—that is the place of business—'31st December, 1922. To Edwin Apfel, Esq. Dear Sir,—Kindly note that I have placed to the credit of your account the sum of £1,000 as a bonus. Yours faithfully, A. Apfel.' The letter to Harry Apfel is in identical terms. Having obtained those letters, the defendants prepared the balance sheet that I have mentioned, putting in it as wages these two sums of £1,000 each, which the mother had sanctioned in the way that I have stated. That left the two sums of £270 and £26 which they entered under the heading of 'Sundry debtors'.

Now during this period the profits made by this business, apart from Mrs. Apfel's drawings, and the drawings of the two sons, amounted to £4,830. There

were moneys coming to these two sons from the business very largely in excess of the £270 and the £26, and the defendants, in the belief that they were signing this balance sheet for the purpose of an income-tax return, drew it up in the way that I have described, and, as far as the tax authorities were concerned, it was a matter of complete indifference to them whether the bonuses were described as such, and whether the £270 and the £26 were entered under the heading of 'Sundry debtors', they being moneys owed to this lady for the overdrawings, and in respect of the overdrawings of her two sons. That is, in substance, what took place with regard to this first period, and I ask myself: Where is the negligence here? Notwithstanding the knowledge of the old bankruptcy, that is the bankruptcy of the father, this business, in eight months, had made a gross profit of £4,830. The whole of the drawings of these two sons were drawn by cheques signed by Mrs. Apfel. As far as the defendants were concerned, her knowledge of the bonuses might well have been arranged by her sons beforehand in principle, if not in amount, and her bonus letters, stilted though they were, were signed by her, brought to the attention of the defendants, and having carefully scrutinised Mr. Bostock and Mr. Lovatt in the witness box, both as to their evidence and their demeanour, I believe them when they say that no suspicion entered their minds with regard to this first period of eight months, and they believed that their balance sheet and profit and loss account truly reflected the result of the business in so far as an income-tax return had to be prepared from them.

I referred a few moments ago to the charge that was made by this defendant firm in respect of these eight months' work, and it was made in this way. On the 31st July, 1923, they wrote to Mrs. Apfel: 'We herewith enclose a note of our charges for services rendered in connection with the audit of your accounts, amounting to 60 guineas', and the enclosure was an account: 'To professional services rendered in auditing your accounts for the eight months ending 31st December, 1922.' How far that places a responsibility for auditing on this firm who, in fact, did not audit the books in the ordinary sense, I will deal with later.

On the 18th October, 1923, that is after these accounts had been sent in, the Inspector of Taxes wrote to Mrs. Apfel with reference to her accounts up to the 31st December, 1922, a request for further information. He asked as to the stock; as to the creditors; as to certain loan accounts; as to the sundry debit balances included in the £4,460, asking for a list of them, as to the wages, and as to many other matters. That was answered on the 19th October, 1923, by a letter signed by Mrs. Apfel. Each one of these queries was answered by her, and the only one which I think is relevant now is as to the debit balances. In her answer she states that they include, with regard to Edwin Apfel, the sum of £270, and with regard to Harry Apfel the sum of £26. Therefore it came to the knowledge of the defendants, prior to their completing the accounts for the year 1923, that Mrs. Apfel was acquainted not only with the bonuses but also with the extent of the overdrawings in excess of these two bonus figures.

I will now deal with the year 1923. For the period ending December of this year the defendants also prepared a profit and loss account and a balance sheet, and on the balance sheet they gave the same limited certificate. Those documents were finally settled and signed on the 11th June, 1924. In the profit and loss account the wages are put down as £5,324. Those again included, or the figure at which they are placed included, the two sums of £1,500 each, taken by or paid to these sons by way of bonus out of this business during the year. The balance sheet showed a profit of £1,014 which showed a drawing, which is in fact Mrs. Apfel's drawing of £827, and as a matter of fact the book profit for this year, apart from Mrs. Apfel's drawings and these two bonus sums, amounted to £3,341. Under the heading 'Sundry debtors and debit balances' amounting to £18,052, there is a very large overdrawn sum standing to the debit of these sons, and I will now deal with that. During the year 1923 the sons again were drawing almost daily large sums out of this business. By the end of the year Edwin's drawings amounted to £6,025. Harry's drawings amounted to £4,892. After deducting credit items appearing in the books there is a balance of £3,678 to the debit of Edwin and £2,658 to the debit of Harry. From those two figures there is deducted in each case a bonus of £1,500 and after deducting those two bonus figures, it leaves an overdrawing by Edwin of £2,178 and by Harry of £1,158, amounting

together to an overdrawing, in addition to bonus and credits, of £3,634 by these two sons.

Before I deal with that, I will say a word or two about some of these credits. In the books in October, 1923, there appears a credit of £1,000 to each of these sons. That has been referred to by counsel for the plaintiff as a shameless juggle. That is entered in the business books, which the defendants had to deal with for the purpose of getting out this income-tax return. The two partners in the defendants' firm did not actually see it, but it was dealt with by an experienced clerk of theirs, who was going through the books for the purpose, after making them up as far as it was necessary, of getting out the position of the business as shown by the books. In order to explain these two figures, I must again refer to the surplus assets of Mr. Apfel, senior's, business. An order of the Court had been obtained, whether rightly or wrongly I do not pause to consider, under which the Court had decided that any surplus of assets of the old business over and above a sum sufficient to pay the 3s. in the £ composition, belonged to these two sons. That was obtained at the instance of Mr. Bostock and he has told me that when he ascertained that there would be this surplus he consulted his solicitor as to what he ought to do. Whether the advice he obtained was good, bad or indifferent does not seem to me to matter if he acted honestly. He took his solicitor's advice. A summons was taken out and counsel appeared and the Court decided that this surplus was payable to these two sons. Whether everybody had forgotten that a large portion of it ought to have been payable to Mrs. Apfel I do not know, but Mr. Bostock, acting on the advice of his solicitor and as far as I can see honestly, was told by the Court that the surplus in his hands was payable to these two sons.

Now with regard to these two credits in October, 1923, of £1,000 to each of these sons, what happened was this: a cheque was drawn for £2,000 payable to the old firm of Apfel Brothers. That cheque was paid into Mrs. Apfel's new business account. On the same day two cheques were drawn on that account for £1,000 each payable to the two sons and on the same day those two cheques for £1,000 each were paid in by these two sons into Mrs. Apfel's business account, the theory of the thing being that as surplus moneys were payable to these two sons, the surviving partners of Apfel Brothers, and as the assets out of which they were payable were in Mrs. Apfel's possession and under her control it was carrying out in a sense the order of the Court that out of those assets, payable to the sons, Mrs. Apfel should pay to each of them a sum of £1,000 and that they, being in possession of that payment, could pay it back into the business account as against their overdrawings. Now whether that is right or wrong, whether it was a juggle or not a juggle, what occurred was this, as far as the defendants are concerned. Their clerk saw these two credits in the books and he made a special note of them, in order to consider them. He knew that surplus assets were payable to these two sons. He knew that these assets were apparently in this business and from his knowledge of Mr. Bostock's trusteeship with regard to the old business he came to the conclusion that these sums were not in excess of a larger sum which was ultimately payable to these two sons, and he passed that credit in these books. I have heard him in the box and am satisfied that he did it honestly, and the defendants were not informed of it by him. If he had not done it honestly, that would not have mattered, but as it is, the credit was found there in the books and under the order of the Court, which had been obtained, rightly or wrongly, that was a credit which was passed and honestly passed under the circumstances.

Another two items of credit call for notice during this period, one a sum of £400 credited to Edwin and the other a sum of £411 credited to Harry. Those again are connected with the moneys payable to these two sons under the order of the Court, and the same thing applies to them. Therefore, we have now got to the position that two bonus sums of £1,500 are credited to these sons for this period, and after allowing those and the other credits entered in the books, there is still left an overdrawing by these two young men of £3,634, which was entered, as had been the smaller sums, for the first period in the balance sheet under the heading of 'Sundry debtors and debit balances'. With regard to the bonus, the same query was raised by the defendants with the two sons, and they were asked

to obtain from their mother an acknowledgment that this was done with her knowledge and consent. On the 31st December, 1923, two letters were again written from 41 Queen Street. They are in the handwriting of one of the sons. They are both signed by Mrs. Apfel and they are to this effect: 'Harry Apfel, Esq.'—again in the same ridiculous form—'Dear Sir, Please note I have credited your account with the sum of £1,500.' A similar letter was written to Edwin. As far as the wording of the letter is concerned, of course it was not accurate. She had not credited their account with anything of the kind, but she had assented to them having drawn out of this account these two sums and was willing that they should be credited and taken to be credited with them by her under these circumstances. The defendants acted upon those letters and this left an over-drawing to be accounted for, over and above these bonuses, of the sum of £3,634, which I have mentioned. This was too much for the defendants, without more explanation, and they drew the attention of these sons to this very large over-drawing. Mr. Bostock on the 13th June, 1924, wrote—I think a memorandum which he signed in these terms dated 13th June, 1924. It is signed 'G. B.', that is Bostock. It is headed: 'Mrs. Adele Apfel, Re accounts to the 31st December, 1923.' It is in these terms: 'I telephoned Mr. Edwin Apfel a few days ago asking him to let me have a letter from Mrs. Apfel approving and confirming the overdraft on the current accounts of Harry and Edwin; Harry £1,184, Edwin £2,449, and I said, after these letters had been received, the amounts due from Harry and Edwin could be included in the sundry debtors and debit balances, they being shown separately.' What that means is this: before signing the balance sheet for the period ending December, 1923, on the 11th June, a draft balance sheet and profit and loss account had been prepared, and in that draft balance sheet instead of lumping together the whole of the sundry debtors and debit balances as £18,052, the draft balance sheet put sundry debtors and debit balances £14,417 and then entered Harry Apfel as owing £1,184 and Edwin £2,449, making the £3,634. Having regard to the fact that these accounts were being prepared for income-tax purposes, Mr. Bostock made the note, which I have read, saying that if Mrs. Apfel approved this balance of over-drawing the accounts could be included in the sundry debtors item as they had been in the previous year. After bringing that matter to the sons' attention a letter was obtained from Mrs. Apfel again by her sons, dated from Queen Street on the 24th June, 1924, addressed to Messrs. Annan, Dexter & Co., the defendants, in these terms: 'Dear Sirs, With reference to the audit of my accounts to the 31st December, 1923, I beg to approve and confirm the overdrafts on the following current accounts, Harry £1,184, Edwin £2,449,' those being the overdrawings in question. Having obtained that letter the balance sheet was drawn in the form that I have mentioned, and although dated the 11th June was not delivered until after the receipt of that letter.

With regard to these drawings, up to a date in August, 1923, these large over-drawings by these two sons during that year were again drawn on cheques signed by Mrs. Apfel. When I say signed by Mrs. Apfel, some of them were signed at her request by her daughter, but it is unnecessary to discuss that.

In August, 1923, Mrs. Apfel gave to her sons the right to draw on her account and to sign cheques upon it for that purpose, so that these overdrafts during the first part of the year were on cheques signed by Mrs. Apfel; during the second part of the year on cheques signed by the sons.

Now a great deal has very properly been made and very naturally made of this staggering amount of over-drawing by these two sons. That they were in fact drawing moneys that the business could not stand is now perfectly obvious, but Mr. Bostock, in the witness box, has said this. He said when he discovered (I am paraphrasing his evidence) this £3,634 balance, after crediting the bonuses, he insisted upon Mrs. Apfel's assent to it and evidence of her knowledge of it, and in addition to that he thought, and I have no doubt he honestly thought, that the surplus moneys still payable to these two sons out of the old business of Apfel Brothers, and which the Court had said were payable to the sons, would be sufficient to meet this £3,634. Whether he is right in that or whether he was not does not seem to me to matter if he was acting honestly. He got the lady's assent to the bonuses. He got her assent to this overdraft and he thought it unnecessary to discuss with her whether the sons, whom she was allowing to overdraw in this way, were or were not able to meet their indebtedness when called upon. He

thought they were. Whether they were or not does not seem to me very much to matter.

On the 1st August, 1924, the defendants forwarded to the Inspector of Taxes the balance sheet and profit and loss account of this business for the year 1923. On the 27th of October the Inspector wrote back to the defendants: 'I thank you for your letter'—that is the letter enclosing the balance sheet—and beg to return the 1923 account in order that Mrs. Apfel may certify thereon that it is true and correct.' That was done, and it is perfectly plain from the certificate on the balance sheets for December, 1922, and December, 1923, that the Inspector of Taxes saw that it was a mere limited accountancy certificate, and he required, in addition, the certificate of the proprietor of the business that the position therein shown was the true and correct position, and he got it. On the 17th November, 1924, the Inspector of Taxes again required further information as in the case of the previous year. He asked, amongst other things, for the particulars of the sundry debtors and debit balances, £18,052, which were entered in the balance for December, 1923. He also asked for Mrs. Apfel's salary and drawings; the salary and commission of the two sons and other matters. On the 6th of December of the same year the defendants answered the Inspector giving him the exact figures of Edwin and Harry's balanced overdrawings, that is the £2,449 and the £1,184. They gave the salary of Harry Apfel as £260, and his bonus as £1,500 and the same in the case of Edwin. Again in this year there is a similar auditing charge as in the year 1922. On the 17th July, 1924, there is a letter in exactly the same terms as before, excepting the amount. It is written to Mrs. Apfel by the defendants: 'Dear Madam, we enclose a note of our charges for services rendered in connection with the preparation and auditing of your accounts for the year ending December, 1923', and the account enclosed is 'To professional services rendered in the preparation and auditing of your accounts.' In addition to that, on the 17th March, 1925, the defendants sent in, or made an entry in their books (I am not sure whether they did both): 'Mrs. Apfel. Fee for services in connection with the adjustment of income-tax liability as noted in letter to Mrs. Apfel dated the 23rd December, 1924, 100 guineas.' Mr. Bostock has explained that in this way. They had charged for the work on these books in the way that I have described. They put down the number of hours they worked, and in connection with those charges in the books there are various items, small amounts, which are initialled 'I.T.' That means income-tax. With regard to this charge of 100 guineas, Mr. Bostock says, and I have seen the correspondence, and I do not doubt him, that in addition to preparing the books for the income-tax return they had a long correspondence with the Inspector for the purpose of trying to induce him to assent to the proposition that Mrs. Apfel's business was a continuation of her husband's business, and that, therefore, she was entitled to the three years' average for the purpose of bringing down her profits. Mr. Bostock says that this 100 guineas was in connection with that special work so conducted. I have no reason to doubt him, and I accept his evidence.

I will now say a word with regard to the charge of negligence. I think I have sufficiently stated exactly what was done during the 1923 period. I will now consider the charge of negligence in connection with this period. The charge is again confined by the pleadings to the bonuses, and the other overdrawings by the sons. Again, as I have said, the defendants knew that Mrs. Apfel was signing these cheques till August, when she expressly authorised her sons to draw on her account. She again sanctioned the bonuses at the same rate as she had given them during the eight months of 1922. She sanctioned and assented to the amount of the additional balanced overdrawings amounting to £3,634. The defendants, before certifying the balance sheet for the income-tax return, obtained her written assent to both the matters complained about, and they have again stated that, under the whole circumstances which they have described, their suspicions were not aroused, as they had Mrs. Apfel's attention expressly drawn to the matters complained of, and the result of them, and they were informed in writing by her of her sanction and assent. The defendants have sworn that the balance sheet they signed for the year 1923 reflected truly the result of the books to the best of their knowledge and belief and I feel bound to accept their evidence as to this under the circumstances.

The second question I referred to earlier is, what the defendants knew or ought to have known during the term of their employment. They knew about the collapse of the old firm and about the drawings that have been mentioned of the father and his two sons immediately prior to the collapse of the old business, but no evidence has been adduced as to the circumstances under which these drawings and the solvency of the old firm took place, nor whose fault it was, and I am of opinion that the defendants were justified in believing that Mrs. Apfel trusted and believed in her sons when she started her business, largely, as it would appear, for their own benefit, in May, 1922. The defendants knew that she commenced her operations on borrowed capital and made considerable profits, and they had no reason to suppose that she was not cognisant of what went on from that day, or to suspect that she did not understand or intend the effect of the documents that she signed, and although other accountants might have thought it wise under the circumstances to have acted differently I am unable to hold that the defendants had such knowledge as made their conduct during this period of employment actionably negligent.

The third question is, what the defendants brought to their employer's notice during their employment with regard to the charges made against them. The answer is that they obtained her written consent to the bonuses and the overdrawings, which are the only matters in respect of which they are charged with having failed in their duty.

The last question is, what remedy, if any, the plaintiff is entitled to in this action. In this connection I will refer shortly to the manner in which the plaintiff seeks to maintain his allegations of negligence notwithstanding the facts that I have attempted to explain. As I have said, he first of all says that this was an audit and not mere accountancy work of preparing for and getting out the income-tax return and the necessary materials for that purpose. Notwithstanding the defendants' charges, which I have referred to as for auditing, I am satisfied that the work they were instructed to do and the work that they actually did do was the latter. Their certificates were given on this basis, and Mrs. Apfel herself had to give the certificates as to the true position of the business required by the Inland Revenue authorities, and the audit charges may have been intended to cover the work done on the books of the business preparatory to getting out the tax returns, or they may have been charged in error. Even if the plaintiff's view is accepted, or ought to be taken, I am of opinion, for the reasons I will mention in a moment, that it would not in this case entitle the plaintiff to succeed. The plaintiff's counsel in his able and eloquent address further contends that Mrs. Apfel's position was never taken into consideration by the defendants at all, but that they acted throughout in the interest of her two sons. Apart from this being a charge of fraud not raised in the pleadings, and disowned by the plaintiff herself, it is in my opinion disposed of by the defendants' evidence. It is impossible to disguise from oneself the fact that now that the dishonesty and fraud of these two sons had been discovered, that had coloured the views and arguments put forward on the plaintiff's behalf. A great deal is made of the fact that a number of the credits entered in these books against the sons' overdrafts, especially in the year 1923, are probably bogus, but the defendants' attention was not called to that. They believed the sons were acting with the knowledge and consent of their mother, that they were trusted by her, and I do not think they are to blame for having adopted a similar attitude. A great deal is made of the covering up in the balance sheet of the overdrawing and of the bonuses but that, as I have tried to explain, if the defendants were preparing, as I believe they were, the accounts of this business for the purpose of ascertaining the income-tax position, was wholly immaterial, and they did not, as I find, disguise the facts complained of from their employer.

Among the many items which have been referred to, and I think quite properly referred to, for the purpose of casting suspicion on the defendants' conduct, which is only relevant, of course, for the purpose of showing that they were negligent, there is a curious item of £1,117 debited in these business books to Mrs. Apfel. Now that sum included the charges of Mr. Bostock as trustee under the composition deeds and assignments with regard to the old business. Mrs. Apfel was permitted to occupy these business premises rent free, and it may very well have been that an arrangement was made between her and her sons that certain

charges of Mr. Bostock and his clerks in connection with the old business should in consideration of that be debited to her, but whether that is so or not this entry appeared in the books of this business kept by these two sons whom Mrs. Apfel employed to manage her business, and I am unable to hold that, from an entry such as that, the defendants were guilty of negligence, having regard to the employment which I have described. The matter really very largely turns upon whether in fact, employed as they were, the defendants' suspicions were aroused by any of these items which have been pressed on behalf of the plaintiff. I have heard them as I have said, and I believe them when they say that they did not suspect the wrong which has now come to light.

Then another rather curious point is made. At the end of 1923 these sons owed this business £3,000 odd in respect of this overdraft, or overdrawings. Mr. Bostock thought that it would be, or might be, a good debt. In 1924 the appetite of these sons for robbing their mother appears to have been considerably whetted by their success in 1923, and in the 1924 books these drawings go on to a monstrous extent. The defendants did not finally prepare their balance sheet for 1923 until June, 1924, and it is said that having regard to what they had known as to overdrawings in 1923, they ought to have looked in the books of 1924, during which period they were not employed, for the purpose of ascertaining whether there was some robbery going on which they ought to have brought to Mrs. Apfel's attention. I do not take that view at all. They had no right to examine the books for 1924, not being employed to do so, and I certainly am of opinion that they cannot, and ought not, to be prejudiced by what might have come to light if they had examined the 1924 books which they did not do, and which they were not employed to overlook. Mr. Bevan, for the defendants, submits that the plaintiff can stand in no better position in this action than Mrs. Apfel would have done had she been plaintiff herself, and that even if the defendants had been employed to make a full audit, which he contends they were not, she could not have succeeded as to the matters complained of, no duty being owed by the defendants to anyone but her, and if she had been plaintiff her signed documents would have been sufficient to show her consent to, and knowledge of, the whole of the matters complained of, unless she had given evidence to the contrary. In this case she has not been called, and she has given no evidence, and there is no proof that she did not intend and understand the documents which she signed. As I have said, there is no allegation of fraud or bad faith open to the plaintiff, and the contentions of the plaintiff's counsel, eloquently and ably made as they were, against the defendants on this footing have been disproved, or not pleaded, and have been disowned by the plaintiff himself.

For these reasons, and those that I have detailed above, the defendants contend that the particular charges in the pleadings, which are the only ones I am entitled to consider, have been sufficiently answered and disproved. I agree with those contentions of the defendants' counsel, and for the reasons which he has given, which I have attempted to refer to, and those which I have dealt with at length, and I am of opinion that the plaintiff's case fails, and that the action must be dismissed with costs.

BURNHAM v. ATLANTIC and PACIFIC FIBRE IMPORTING
AND MANUFACTURING CO. LTD.*

(Decided by CLAUSON, J., in the High Court (Chancery Division) on the 5th July, 1928)

A balance sheet contained in an annual report sent by a company to its shareholders and filed with the Registrar of Companies and stating the total amount of the company's indebtedness under its debentures for principal and interest accrued thereon since their issue is, although not sent to the debenture-holders, a sufficient acknowledgment by the company of their liability under the debentures to take the case out of Section 3 of the Civil Procedure Act, 1833.

This was an action by a debenture-holder in a company incorporated in 1883 who claimed, on behalf of himself and of all other debenture-holders of the company, an account of all moneys due to himself and to them by way of principal

* [1928] Ch. 836; 72 *The Accountant* L.R. 71.

and interest, and payment of the same. The amount which the company had raised by the issue of debentures was £23,925 8s. 6d., and this had been done during the period covered by the years 1890 to 1902. The plaintiff received his debenture on 19th November, 1890, and it was of the same amount as all the other debentures, viz. £1,110 11s. 8d. In it was a covenant by the company for payment to the person named in the debenture or other the registered holder thereof for the time being of interest at the rate of 10 per cent., such payment being by half-yearly instalments, and also for payment, on a date two years after that of the debenture, of the principal sum. The contention of the plaintiff was that the company had made no payment whatever in respect of the debentures, either by way of principal or of interest; the company did not deny this, but did deny the further contention of the plaintiff that the whole amount, both principal and interest accrued thereon, was consequently owing by the company to the debenture-holders. During the years 1907 to 1926 inclusive, the company had issued balance sheets, in each of which the amount of £23,925 8s. 6d. was expressly stated to be owing on debentures, while in that of the year 1926, the sum of £80,733 2s. 7d. was entered as accrued interest on debentures. All debenture-holders who were shareholders of the company, of whom the plaintiff was one, received notices and reports in which copies of the said balance sheets, signed by directors of the company, were included, and similarly signed copies were annually filed with the Registrar of Companies. The plaintiff, in answer to the company's defence that the claim of the debenture-holders was statute barred by Section 3 of the Civil Procedure Act, 1833, therefore contended that the said signed balance sheets constituted an acknowledgment by the company that the moneys claimed by himself and the other debenture-holders were in fact due and owing.

Clauson, J., held that the issue of the balance sheets constituted, in the circumstances, a sufficient acknowledgment of the company's indebtedness under the debentures. The question was whether the statement in the balance sheets, contained in the notices and the reports, constituted an acknowledgment within the meaning of Section 5 of the Civil Procedure Act, 1833. It was contended on behalf of the company that the acknowledgment was not given to all the debenture-holders. But the Act did not require that the acknowledgment should be so given, and such an acknowledgment need not amount to a promise to pay, and need not be made to the party making the claim. There would be a declaration that the claim of the plaintiff and other debenture-holders against the company, for principal and interest, was not barred by any statute of limitations, and there would be liberty to apply.

In re JOHN FULTON & CO. LTD.: THE OFFICIAL LIQUIDATOR *v.*
THE COMPANY AND HENRY JENKINSON AND CO.*

(Decided by WILSON, J., in the Ulster Chancery Division, 23rd February, 1931)
Company—Dividends wrongly paid—Misfeasances—Breach of trust—Directors' and auditor's liability

This action was brought by the Official Liquidator (Mr. Arthur Henry Muir, F.C.A.) against the directors and auditor of John Fulton & Co. Ltd., for misfeasance or breach of trust relating to £70,000.

Mr. Muir applied for an order that George H. Fulton, 45 Ulsterville Avenue, Belfast, warehouseman; David Fulton, 36 Myrtlefield Park, Belfast, warehouseman; and John Fulton, 23 Sans Souci Park, Belfast, warehouseman, directors of the company, and Henry Jenkinson & Co., Rosemary Street, Belfast, auditors and registrars of the company, be declared liable to make good and contribute to the assets of the company by way of compensation in respect of misfeasance or breach of trust the following sums:

£10,312 10s. paid as half-yearly dividends on the preference shares of the company during the years 1927, 1928 and up to and ending 1st August, 1929.

£45,000 or such sum as may be found payable in respect of a guarantee dated 29th September, 1928, given to the Ulster Bank Ltd. by the company on behalf of the Caledon Woollen Mills Co. Ltd.

* [1932] N.I. 35 (Irish); [1931] *The Accountant* L.R. 17.

£5,000 lent on 7th October, 1927, by the company to the Caledon Woollen Mills Co. Ltd.

£5,600 or such sum as may be found payable by the company in respect of the liability of the company with regard to certain accommodation bills accepted on behalf of the Caledon Woollen Mills Ltd., up to and ending 25th February, 1930.

£4,349 or such sum as may be found payable by the company in respect of the liability of the company with regard to the endorsement of bills accepted by the Caledon Woollen Mills Co. up to and ending 25th February, 1930, on the grounds that the sum paid in dividends was paid out of capital instead of income, and as regards the other sums on the grounds that the liability for these was incurred on the basis that certain balance sheets were true and accurate statements of Fulton & Co. Ltd. and of the Caledon Woollen Mills Ltd., whilst at the same time they were false and misleading. The facts are fully set out in the judgment.

JUDGMENT

WILSON, J.: This is an application by the liquidator for an order that the three directors of the company, viz. George H. Fulton, David Fulton, and John Fulton, and Henry Jenkinson, trading as Henry Jenkinson & Co., auditor and registrar of the company, might be declared liable to make good and contribute to the assets of the company by way of compensation in respect of misfeasance or breach of trust.

Having recited the terms of the summons as set out above, his lordship said it was necessary to state shortly the history of the two companies and to ascertain the facts in relation to the alleged misapplication, misfeasance, breach of trust, alleged against those four men. The business of the Fulton Co. was started in 1864 by the late Mr. John Fulton. He sold his business to John Fulton & Co. Ltd. in the year 1898. The original capital of the company was £80,000 divided into £8,000 5½ per cent. preference shares of £5 each, and 8,000 ordinary shares of £5. The preference shares were offered for public subscription under a prospectus dated 26th July, 1898. The business was sold to the limited company by John Fulton, senior, for £40,000, which included £14,320 for goodwill. The purchase money was paid by the issue of 7,876 ordinary shares of £5 each, and the balance in cash or preference shares. The purchase of the business was the first object of Fulton & Co. Ltd., stated in the memorandum of association. The subscribers of the memorandum of association were John Fulton, his three sons, the impugned directors, William Fulton, another son, William M'Bratney, and S. A. Moore, and they took in all 124 ordinary shares. On the 7th September, 1908, the authorised capital of the company was increased by £80,000 to £160,000, the increase divided into £12,000 5½ per cent. preference shares, and 4,000 ordinary shares of £5 each and 7,000 preference shares of £5 each were issued, making the total capital then issued £115,000, being £40,000 in ordinary shares and 75,000 preference shares. In September, 1917, 2,400 ordinary shares of £5 were issued, making the issued capital 10,400 ordinary shares of £5 each, and 15,000 5½ per cent. preference shares of £5 each, or a total issued capital of £127,000, at which figure it continued till the date of the liquidation.

On the 16th October, 1905, Henry Jenkinson, carrying on business as Henry Jenkinson & Co., chartered accountants, the fourth person sought to be made liable, was appointed auditor of the Fulton Co. Ltd. on the terms: (1) that he did all the private work himself; (2) that the half-yearly account be completed not later than 7th August and 7th February in each half-year, and he was re-elected annually afterwards, and remained auditor of the company till liquidation. He was also registrar of the company and auditor of the Caledon Co. (which was a private company) from its incorporation till it went into liquidation.

Under the articles of association of the company, it was provided that 'so long as the preference shareholders receive their full preference dividend not later than 18th February and 1st August in each year, the preference shares shall not confer on the holders thereof the right to notice of or to attend at general meetings of the ordinary shareholders or at any other meetings, unless a proposition is to be submitted which directly affects their rights and privileges, nor shall they be entitled to inspect the books or accounts of the company or to any copy or extract therefrom.'

In addition, the company were entitled to have, and had, deposited with them at interest large sums of money, amounting at the date of liquidation to £21,511, and the only protection the preference shareholders and those depositors, amounting in all to £96,511, practically all invested by the customers of the company and other members of the public, had, was the protection given them by Section 26 of the Companies (Consolidation) Act, 1908.*

Before the war the company was prosperous. During the war, and up to June, 1920, the net profits, after paying excess profits duty, were £135,616. The net losses in the year ending June, 1921, were £64,402. From June, 1921, to June, 1929, the results varied, and the total profits, as shown by the books, were £22,569, and the total losses were £17,876, or a net profit for eight years of £4,693.

It took £4,125 per annum to pay the preference dividend, and £33,000 was paid in those eight years in respect of preference dividend, and in addition £3,225 was paid in respect of ordinary dividend, making in all £36,225 paid in those years out of a profit of £4,693 actual profit made and out of any other fund or property that could be made available therefor.

That the directors were aware of the serious position of the company's finances was shown by the table made out by the liquidator in his affidavit, which showed that the three directors inpleaded therein paid no dividend to themselves in respect of the £3,100 ordinary share capital held in their own right after June, 1922, till liquidation in January, 1930. That was further shown by the fact that from 1921 up to December, 1924, George Fulton, David Fulton, and John Fulton were paid £1,300 and upwards a year for salaries as directors, and the salaries were voluntarily reduced to £200 a year from June, 1924, to the liquidation; John Fulton was further paid £800 a year from June, 1921, till June, 1924, £525 for the year 1925, and £200 for the year 1926 as director of the Caledon Co., and nothing from June, 1926, till liquidation.

It was also proved that the stock books were signed each year by the respective heads of the company's departments, and were taken 'at cost price or market value' and not 'at cost price or market value, whichever is the lower'. In consequence the stock was overvalued, and at the date of liquidation a considerable quantity of stock which was old and depreciated was included in the latest stock books at cost price. It was suggested that was done deliberately on the instructions of George Fulton, but no legal evidence of that was given before him.

In addition, from December, 1925, to the year ending June, 1929, considerable sums were spent on advertising, amounting in all to £13,346 8s. None of that expenditure was charged against profits, but the whole sum was carried forward in the ordinary balance sheet prepared as a good asset. Also depreciation of plant and machinery was not properly provided for, and the balance sheet value of both plant and machinery was thereby improperly inflated.

Next, as to the Caledon Co. In the year 1902 the company bought the assets of the Caledon Woollen Mills for £9,030 13s. 11d., and it became the woollen manufacturing department of the company, and on 4th August, 1910, the company sold the Caledon Woollen Mills to the Caledon Woollen Mills Co. Ltd., as from 4th June, 1910. The Caledon Co. was incorporated on 4th August, 1910, to purchase and carry on the business of the Caledon Woollen Mills. The sale price was £54,150, which was paid by allotting 5,000 £1 shares, the whole capital to the company's business, and the balance by cross cheques, whereby the company became unsecured creditors of the Caledon Co. for £49,150.

In addition, the company were credited with £3,567 13s. 10d., being the amount expended by them from 4th June, 1920, to 4th August, 1920. On 3rd December, 1920, the company were creditors of the Caledon Co. for £46,769 10s. 8d. The sale of the Caledon Woollen Mills resulted in the book profit of £11,349 12s. 10d. made up of £5,000 charged for goodwill and increased value of machinery and plant £6,349 12s. 10d. The book profit was realised during the war boom, when the Caledon Co. repaid to the company all the money due on the sale. That book profit was capitalised by the company in 1917, when they issued to the ordinary shareholders 2,400 ordinary shares of £5 each fully paid.

The directors of the Caledon Co., since the death of John Fulton in 1915, were George Fulton (chairman), David Fulton and John Fulton, and Henry Jenkinson was the auditor from the incorporation of the Caledon Co. to its liquidation. The

* Now Sections 124 and 128-128 of the Companies Act, 1948, as to the filing of an Annual Return.—Ed.

company owned all the shares of the Caledon Co., which was not prospering, and in 1915 the company wrote off £5,000 of the Caledon Co.'s debt, but that was cancelled in June, 1918, when the Caledon Co. was making large profits. The company's loan was to bear interest at 5½ per cent., but no interest was charged against the Caledon profit and loss account till 1916, but by June, 1917, the entire interest to date was paid up.

On the 5th December, 1915, £48,712 7s. 1d. was due to the company, and by 4th December, 1920, the Caledon Co. repaid all that, and also their indebtedness to the Ulster Bank. During the war boom, from 1916 to 1920, the Caledon Co. made £97,842 less excess profits duty of £45,245 11s. 2d., or £52,596 8s. 10d. net profit. Then the slump came and the Caledon Co. made losses every year. From December, 1920, to the end of 1929, losses amounting to £62,403 were made, less £12,142 excess profit duty refunded, or £50,261 net loss. The balance sheet of 30th November, 1929, showed a debit of profit and loss account of £3,641 8s. 9d., which amount wiped out the small capital of £5,000. The balance sheet of November, 1926, showed the capital entirely lost, and the balance sheet of 1929 showed the Caledon Co. entirely insolvent. As the Caledon Co.'s affairs became worse, the Ulster Bank asked the Fulton Co. for a guarantee of the Caledon Co.'s overdraft, and the company gave guarantees of the overdraft as follow: 3rd February, 1925, guarantee £30,000, overdraft £35,000; 31st March, 1927, guarantee £35,000, overdraft £36,748; 29th September, 1928, guarantee £45,000, overdraft £45,958.

On 3rd February, 1925, the Caledon Co.'s balance sheet of 29th November, 1924, showed assets £49,015, liabilities £42,522, and capital £5,000, a surplus of assets over liabilities of £1,493. As the assets included £5,000 for goodwill it was almost certain that the paper surplus did not in fact exist. The Fulton Co.'s balance sheet at 3rd December, 1924, only showed a surplus of £29,868. On 31st March, 1927, when the second guarantee was given, the Caledon balance sheet of 30th November, 1926, showed assets £36,900 (including £5,000 for goodwill) against liabilities of £38,866, and capital £5,000, and the Caledon Co. were including the capital of £5,000 insolvent even on paper to the extent of £1,950. The Fulton Co. showed a surplus on paper of £21,533 in their balance sheet at 31st December, 1926.

It was clear that the action of the Fulton directors in increasing the bank guarantee by £5,000 prejudiced the interests of their preference shareholders, the amount of their guarantee, which was certain to be called on, being much larger than the amount of their paper surplus. Further, on the 7th January, 1926, the company accepted accommodation bills on behalf of the Caledon Co. for £3,900, continued to accept further bills for the Caledon Co. till 15th February, 1929, at which date the amount due was £5,600, and since 1928 their bill transactions were not recorded in the company's books. In addition, on 7th October, 1917, the company lent the Caledon Co. £5,000 without security by handing over to the Caledon Co. £5,000, received by the company from a depositor on that day.

On 29th September, 1928, the company gave the Ulster Bank a guarantee of the Caledon overdraft for £45,000, being an increase of £10,000 over the previous guarantee. The Caledon Co.'s balance sheet of 31st May, 1928, showed assets (including goodwill £5,000) value £40,789, and liabilities £53,014, making a deficiency (apart from the £5,000 capital) of £12,225. The company's own balance sheet of 30th June, 1928, showed only a paper balance of £16,974, which still further prejudicially affected the preference shareholders. The accommodation given by the company to the Caledon Co. at 29th September, 1928, was £53,000, viz. £45,000, £3,000 accommodation bills and £5,000 loan.

From the middle of 1928 onwards the company guaranteed, by endorsement, bills issued by the Caledon Co. and though no exact account of these transactions was kept in the company's books, at January, 1930, the date of the liquidation of both companies, the value of the bills so endorsed and not matured was £4,349, bringing at the date of liquidation the accommodation given to the Caledon Co. by the Fulton Co. to the sum of £59,949, viz. guarantee £45,000; accommodation bills £5,600, loan £5,000, and bills endorsed £4,349; all of which sum some 2s. in the £ has now to be met out of the Fulton Co.'s assets to the loss of the preference shareholders.

The remaining matter which has to be investigated is the amount standing

to the general reserve fund. In the year 1920 there stood in the books of the company a sum of £90,000 to credit of this account. In September, 1921, a sum of £60,000 was withdrawn from this fund to meet the slump in stock values, and the following sums were withdrawn from it subsequently: September, 1925, £3,000; September, 1926, £3,000; September, 1927, £2,500; September, 1928, £6,500; and September, 1929, £8,000, making a total of £23,000. These were withdrawn by resolution passed at the general meetings of the company to meet the preference dividends paid on 1st February and 1st August prior to such meetings, and as far as the paper accounts were concerned, showed that such dividends were paid in those years either wholly or partly out of past undivided profits.

That the general reserve fund had long since been wiped away by losses was to him quite clear, said his lordship. The paper accounts showed that from 1925 to June, 1929, there was a considerable loss in trading every year, rising from £814 18s. 9d. in June, 1926, to £4,526 11s. 5d. in June, 1929. If, as everyone knew, or ought to have known, that the assets included £5,000 in capital, and £5,000 loan to the Caledon Co., £10,000 off the goodwill, and £10,000 to £13,000 money spent for advertising, making in all £30,000 to £33,000, the balance standing in those accounts to credit of general reserve funds, varying from £27,000 in June, 1926, to £15,000 in June, 1929, would be entirely wiped out.

'Such in my judgment', said his lordship, 'is the result of the examination of the accounts as appearing in the books and accounts of these two companies, and without taking any account of the contingent liabilities incurred by the Fulton Co. on behalf of the Caledon Co., and which during these years from June, 1926, to June, 1929, varied from £30,000 to £52,000. During all these years, these contingent liabilities were actual liabilities as soon as the Ulster Bank chose to move for judgment.'

Turning from those interesting paper accounts to the realities of the situation, continued his lordship, article 113 (15) of the articles of association gave the directors power before recommending any dividend to set aside out of the profits of the company such a sum as they might think proper as a reserve fund to meet contingencies or for equalising dividends or for repairing or maintaining any profit of the company or for such other purposes as the directors should in their absolute discretion think good for the interests of the company and to invest such sums upon such investments (other than shares of the company) as they thought fit, and to buy such investments, &c., and with full power to employ the assets constituting the reserve fund in the business of the company, and that without being bound to keep the same separate from the other assets.

The reserve funds did not seem to have all been credited out of the profits of the company, but whatever was the source, it was never separately invested, but thrown into the business and with the other assets of the company and mixed with the other assets of the company. That fund, or any part of it, was not available for the payment of dividends till the directors resolved to so apply it.

The preference dividends paid in the years 1926-27, 1927-28 and 1928-29 were all paid when there was a loss of profits and before any such resolution was passed by the directors. In September of each of those years, resolutions were passed withdrawing sums from the general fund sufficient to make it appear that those were profits available to pay those dividends.

Articles 125 to 128 related to the payment of dividends which must be paid solely out of profits, but the directors had power from time to time to pay such interim dividends as in their judgment the position of the company justified. In his judgment that article could not justify the directors in paying the dividends during those years, as having regard to what they knew, or must be taken to have known, of the state of the company no honest judgment could have been possessed by any of the directors that the position justified the payment of these dividends out of the profits, past or present, of the company, and the article, in any case, only applied to interim dividends, and not the final dividend paid each year.

It remained to state that under Article 164 the directors and the auditor of the company were not liable for each other's neglects and defaults, or for any other loss or damage whatever, which should happen in the execution of their respective offices, or in relation thereto, unless the same happened through his own wilful act or default.

The question for decision, therefore, was: Were these directors and auditors or any of them liable for any misfeasance or breach of trust in relation to the several items mentioned by which the company had suffered any loss, and was such misfeasance or breach of trust due to the wilful act or default of the directors or any of them or of the auditors?

The defences of the three directors were that Mr. George Fulton was in a nursing home and not well enough to say anything for himself, and the other two directors said that they respectively attended—David Fulton to the manufacturing end of the business in Ormeau Avenue and John Fulton to the manufacturing end of the business in Caledon, County Tyrone—and they both left the financial business of the company to their brother George, the financial director, and the auditor, Jenkinson. No balance sheet was ever submitted at the annual meetings of the company. Only an account in the form of a directors' report, signed by Mr. G. Fulton, was submitted. Mr. Jenkinson attended all those meetings, and the business at them was carried out according to his instructions.

That the slump in 1921 took away three-fourths of the profits of the previous four and a half good years; that they were not responsible for this; that the directors did not accept any dividends after September, 1922, on their ordinary shares, but share dividends were paid to the other shareholders till September, 1925. They denied that their stocks were overvalued, and Mr. Muir admitted this. They denied that any instructions were given by them or to their knowledge by Mr. George Fulton, to any of their co-employees to take stock on a wrong basis.

He found that there was no evidence of any intentional undervaluation of stocks by any of the directors, as the only evidence thereof was hearsay, and any evidence to that effect to be gathered from Mr. Jenkinson's own evidence was evidence on which he refused to act.

At the same time, whether intentional or not, some of the stocks were overvalued and should not have been valued at cost price, as mentioned in Mr. Muir's affidavit.

They justified the money spent on advertising and said they believed they were justified in treating this not merely as a valid expenditure, but as a capital asset in the nature of goodwill to be written off out of future profits. They seemed to have known all about it, and took the above view of the matter. They also justified the values of the machinery and plant appearing in the balance sheet, and justified not having written off more for depreciation. They said they saw no balance sheet of the company till near the end of 1929, and did not know how the shares of the Caledon Company were treated in them, and apparently that they should get credit for the difference between the balance sheet value of the company's premises of £28,012 4s. 7d. and the price realised for the Howard Street premises at the liquidation, £35,000, and the one apparently should be set off against the other.

They attempted to justify their commitments to the Caledon Co. by saying it made large profits in 1920, and then made large losses, but they thought it could be put on a profitable basis. They admitted that they carefully considered the situation and came to the conclusion that the losses were partly due to mismanagement and they appointed a new manager in January, 1928. They tried to make it again profitable, as it was an advantage to the Fulton Co. They said they did this in the best interests of the Fulton Co., but admitted that they might have been guilty of an error of judgment in regard to it. Their efforts, they admitted, were unsuccessful, but they said the decision had been taken before to wind it up before they decided to wind up the Fulton Co.

This decision was evidently an afterthought and no trace of it was to be found in the directors'-minutes of the Caledon Co. meetings, the only place such a decision of the Caledon Co. would arise or appear. It was because of the great assistance to the Fulton Co. that they gave the guarantee to the Ulster Bank, and also assisted the Caledon Co. by accepting and endorsing their bills. They also alleged that the memorandum of association gave them power to guarantee the contracts, or otherwise assist any company engaged in any business that the Fulton Co. was authorised to carry on.

They said the Caledon Co. was such a business, and that they were, therefore, authorised to give the guarantee and to accept and endorse the bills for the

Caledon Co. They said they did this honestly and bona fide, and to the best of their judgment and ability in the interests of the Fulton Co. They said they discharged their duties as directors of the Fulton Co. honestly and faithfully, and to the best of their judgment and ability; that they had sacrificed themselves in the interests of the company, and lost all their means.

They complained that their salaries during the years 1927-28-29 were so small, £200 a year each, that they were insufficient to pay their living expenses, and that Mr. George H. Fulton had to overdraw his account to the extent of £2,192 12s., which he now owed to the company, and Mr. David Fulton had to overdraw his account to the extent of £240 5s. 6d., which he also now owed to the company.

In the result, they seemed to think that they were far more to be pitied than blamed. They had no further defence.

Whatever he (his lordship) might conclude about their other defences, he should just point out that there was no charge of converting any of the moneys of the company to their own use brought against any of the directors in the present application, but these moneys, drawn by George and David Fulton from the company's coffers, at a time when it was alleged that they knew, or ought to have known, that the company was insolvent, that the ordinary share capital was all lost, was the only foundation there could be of dishonesty against the directors.

He would point out that it might be honest for the directors to overdraw their accounts with their own company, so long as the company had the security of their shares against any sums so overdrawn with interest; but where their shares had no value, to take money from the company for their own private expenses, was simply applying the assets of the company, which should go to keep down the company's overdraft in the bank, and the bank's interest thereon. This seemed to him little short of embezzlement, and excited no sympathy in him for these directors whatsoever. It meant taking the money of the creditors and preference shareholders and spending it on themselves.

The auditor (Jenkinson) said he felt innocent of all misfeasance or breach of trust, and that everything he did was quite right.

He also said that no fault could be found with his conduct. That he prepared all the accounts and directors' reports, and that he had read and actually quoted to him many passages from the law books showing that there was no law against writing up the assets of the company and keeping premises at cost price when they had depreciated in value, or hiding the £13,000 odd spent on advertising as a good asset under the item 'sundry account' in the original balance sheet and condensing it in the summary balance sheet sent to the Registrar of the Joint Stock Companies under the title 'sundry debtors'; that the same was true about another £8,000 odd spent on furniture, paper and twine, office fixtures and packages, and included under the same heading and claimed as a good asset.

Future profits would, he claimed, if the company continued long enough, pay for the lot, and they all tended to increase such profits and were properly entered as assets and should not be put into the balance sheet as expenditure; that this was a private company and it was at least doubtful whether the list and summary provided by Section 26 of the Act of 1908 should be sent to the Registrar of Companies at all; that the preference dividends were all paid out of income, and so long as the balance sheet showed a reserve fund sufficient to pay them over and above the loss on trading for the year, they were properly paid, and that this was the case down to the last balance sheet in 1929; that he never had a balance sheet of either of the companies signed by two directors, and never attached an audited report to such balance sheet or had any reference to such a report attached to the balance sheet, nor was such a report ever read before the company in general meeting, and no such balance sheet or any balance sheet was ever issued, circulated or published, with or without an auditor's report, so there was no breach of duty under Section 113* of the Companies Act. He further stated that anything he did wrong he did under the personal direction of Mr. George Fulton, and he was only an employee and had to obey orders.

The great difference between a business owned by an individual and a business conducted by a limited company was that the only money invested in a private business was the money of the owner, but the money invested in a limited com-

* Now represented by Sections 155, 156 and 162 (2) of the Companies Act, 1948.—Ed.

pany, which was not a private company, was money invested in shares of the company by members of the public.

The Fulton Co. was not a private company. It had invited the public twice to subscribe for preference shares in the company, once in 1898 for £60,000, and again in 1908 for £35,000, and the public had subscribed this.

Under these circumstances the protection given to the public was given by the Companies Act of 1908 under, *inter alia*, Sections 26, 113 and 215.* The auditor acted as general accountant, financial adviser and registrar, as well as auditor for both companies, and knew all about the accounts and liabilities. He prepared the summarised balance sheets purporting to be a compliance with Section 26 (3) and (4) and at the foot signed the words 'Audited, Henry Jenkinson'. He caused this to be forwarded to the Registrar of Companies under Section 26 (4) and thereby represented to the Registrar and to the public that the balance sheet referred to in Section 113 existed, signed by two of the directors and duly audited by the auditor with his report, stating that he had obtained all the information and explanations required, and that in his opinion the balance sheet referred to and the auditor's report were properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of the auditor's information and the explanations given to him and shown by the books of the company.

This was a false representation to the knowledge of the auditor, Jenkinson, and his attempt to get out of this by stating that the word 'audited' to which he signed his name only meant 'examined' was simply ridiculous. Whatever other penalties these annual false representations might expose Jenkinson to, he did not think they could make him liable in this application, for none of the loss complained of was caused by these falsehoods.

It might have lulled the creditors and preference shareholders and the Ulster Bank to sleep, but it did not cause the directors to give the accommodation or loan to the Caledon Co., or the guarantee to the Ulster Bank for the Caledon Co., or to pay any of the preference dividends complained of, as such dividends were each year already paid before the false document was forwarded to the Registrar of Companies. Nor did he think that the auditor or anything he did or left undone caused the directors to give the accommodation or loan to the Caledon Co. or the guarantees to the Ulster Bank. The directors, and not the auditor, did those things, and they, if any, were alone liable in respect of them.

The only question left as regarded the auditor was the payment of the preference dividends. To establish that liability the duties of the directors and of the auditor must be clearly understood. A director was at least an agent of the company to conduct and manage the business, subject to the provision of the Companies Act and within the provision of the memorandum of association, and according to the powers given them by the articles of association. These provisions presumed honesty on the part of both directors and auditors, and assumed that the directors would use at least the ordinary care and skill a man would use in the conduct of his own affairs.

Could such a director escape liability if he accepted such an agency by saying that he was entirely ignorant of his duties, and that he only saw the reports submitted at the annual general meetings, and left all the financial matter of the company in the hands of George Fulton, whom they looked upon as the financial director, and the auditor, whom they relied on to keep everything right?

In my judgment such a director cannot escape such an agency, and be paid for his work as such agent, and be allowed in a Court of Justice to say that he knew nothing about the provisions of Sections 26 and 113 of the Companies Act, 1908, and also the provisions of the memorandum and articles of association of the company. He must in a Court of Justice be assumed to know that the annual list of members and other matters mentioned, including a statement in the form of balance sheet, audited by the company's auditor, and containing a summary of its share capital, its liabilities, its assets, giving such particulars as will disclose the general nature of their liabilities and assets, and how the value of the fixed assets have been arrived at, shall once in each year be prepared, and a copy must be forwarded to the Registrar of Companies each year.'

* Section 215 of the 1908 Act was the 'misfeasance' section; now Section 333 of the Companies Act, 1948.—Ed.

He must, continued his lordship, also be presumed to know that 'the balance sheet, audited by the company's auditor', was the balance sheet signed by two of the directors of the company, and handed to the auditor to be audited, and that the auditor must make a report to the shareholders on the balance sheet and accounts so examined, and on every balance sheet laid before the company in general meeting, which should state:

- (1) That having obtained all the explanations and information they have required;
- (2) Whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.

The balance sheet must be signed on behalf of the board of directors, and the auditor's report must be attached to the balance sheet, or there should be inserted at the foot of the balance sheet a reference to the report, and the report must be read before the company in general meeting, and must be open to inspection by any shareholder. A penalty of £50 was imposed for issuing, circulating or publishing any copy of a balance sheet which had not been so signed, or any copy of a balance sheet without having a copy of the auditor's report attached, or containing a proper reference to such report, on any director or officer of a company who knowingly was a party to such default.

In the *Fulton Co.* the proper carrying out of these provisions was the only safeguard the preference shareholders and depositors and creditors had, as the articles of association deprived them of all their protection. The provisions of the section he (his lordship) had referred to were never carried out by the directors or the auditor. **The balance sheets were not prepared by the directors and were never brought before any general meeting of the directors. Balance sheets were prepared by Jenkinson, but contained no report; no report was ever made to the shareholders as required by Section 113 (2) and consequently the list and summary sent to the Registrar of Companies, and stated to be 'audited by the auditor', was false. No summary, as required by law, was ever sent to the Registrar of Companies by the *Fulton Co.***

'Surely that was misfeasance', continued his lordship, 'and a breach of duty. Was the non-preparation of a balance sheet by the directors, and the not auditing and reporting on such balance sheet and the accounts of the company wilful act or default on the part of the directors and the auditor? In my judgment it was.

'In law they knew it was necessary, and in fact they did not do it or make any attempt to do it. Instead, they allowed a false summary, purporting to show it was done, to be forwarded to the Registrar of Companies. It remains to ascertain if the payment of these sums or any of them was due to such wilful act or default.

'If the balance sheet up to 31st December, 1926, had been properly audited by Jenkinson and brought before the general meeting on 7th September, 1926, would he not, if honest, have reported that the £88,406 6s. 11½d. was partly composed of expenditure for advertisements and other items which had not been charged to profit and loss; that the investments included £5,000 invested in the share capital of the *Caledon Co.*, which had been run at a loss for many years, and that in addition there was a contingent liability due on foot of a guarantee for £30,000 in respect of the *Caledon Co.*'s overdraft of £35,220, which would have to be paid by the *Fulton Co.* at any time they chose to demand it, and there was no prospect of getting any of these sums paid by the *Caledon Co.*, and, therefore, that the reserve fund, stated to be £24,000, was really non-existent? Can anyone doubt that if such a report had been made, the directors would have paused before they paid the preference dividends on 1st February, 1927, and 1st August, 1927?

'Similarly, if an honest report had been made by the auditor on the balance sheet and accounts made by him for the year ending 30th June, 1927, could they have dared to pay the preference dividends paid on 1st February, 1928, and 1st August, 1928, when the directors were aware that an additional £5,000 had been advanced to the *Caledon Co.* on 7th October, 1927?

'Again, if a similar honest report had been made by the auditor in the balance

sheet prepared by him up till June, 1928, and if it had stated that the contingent liability was now £30,000 on the guarantee and £4,177 8s. 1d. on bills discounted for the Caledon Co., and £5,000 more for the loan to the Caledon Co., it is impossible to imagine that the directors would have had the audacity to pay the preference dividends paid by them on 1st February and 1st August, 1929.'

I am therefore clearly of opinion that the wilful act and default of the auditor Jenkinson was one of the joint causes why the preference dividends paid in the years 1927, 1928 and 1929 were wrongly paid by the directors to the preference shareholders, and that he is liable to pay the sums so paid to the company by way of compensation.

As, however, the liquidator is of opinion that there is some doubt as to whether the sums paid in the year ending June, 1927, might not properly be paid by way of preference dividends, I only order Jenkinson to repay the dividends to the preference shareholders which were paid in the years 1928 and 1929, amounting to £8,248, and he must also pay the costs of this application so far as same have been incurred by the ascertainment of this liability.

I am also of the opinion that the three directors are clearly liable to recoup the company by way of compensation for the dividends actually paid to the preference shareholders in the years 1928 and 1929. If they had not wilfully neglected their duties as directors and failed to have proper balance sheets prepared and audited and reported on by the company's auditor and brought such reports before the general meetings of the company, these dividends could never have been paid, and which are in fact the loan paid by the directors entirely regardless of whether they were paid out of capital or profits.

When one turned from the accounts, balance sheets, books, &c., to the bank account of the company, one found that they had in reality only one bank account into which all the liquid assets of the company were paid, to which all receipts were lodged. Shortly before the preference dividends for the years 1928 and 1929 were paid, a sum sufficient to pay each half-yearly dividend was withdrawn and lodged to another account called the preference dividend account, and those dividends were paid out of that account accordingly.

'In fact', went on his lordship, 'in these years 1928 and 1929, by means of an overdraft, or in other words the overdraft of the company was on each of these four occasions increased by the amount necessary to pay these half-yearly dividends. Prima facie, therefore, these dividends were in fact paid by money borrowed from the bank, and no sum was in fact pretended to be drawn from the general reserve till the subsequent general meeting of the company held in the following September of each of these years. In reality there was no such general reserve fund in those years. It only existed on paper if the contingent liabilities which were only postponed by the bank being misled by false balance sheets which they assumed had been properly audited and reported on.

'They are also to compensate the company in respect of all sums which may ultimately have to be paid in respect of the guarantee of £45,000 in respect of the Caledon overdraft and of the bills accepted and endorsed. At the time these guarantees were given and these bills were accepted it was quite clear, or should have been quite clear, but for the reckless carelessness of the directors, that these moneys could never be met by the Caledon Co., and it is not true in any way that these liabilities were, or could have been, incurred in the interests of the Fulton Co., and the same holds true of the loan of £5,000 to the Caledon Co. in October, 1927.

'I hold as a fact on the evidence that the loan of £5,000 was given, and all these contingent liabilities were incurred by the directors not in the interest of the Fulton Co. at all, but solely to put off the evil day when both companies would have to go into liquidation, and were given and incurred entirely regardless of the interests of the Fulton Co., and solely to bolster up the Caledon Co., which the directors knew was hopelessly insolvent.

'If demonstration was necessary it is shown by what occurred when the bank pressed for security, and asked for the title deeds of the Howard Street premises to be lodged with them as security for the Fulton Co.'s liabilities to them. This was refused, and the resolutions for voluntary liquidation were passed of necessity and at once.

'I accordingly order that these directors must recoup to the company the sum of £5,000 in respect of the loan to the Caledon Co. for October, 1927, and whatever sums the company have eventually to pay in respect of the contingent liabilities the Fulton Co. have to pay in respect of the guarantees to the bank and on the bills accepted and endorsed by the Fulton Co. on behalf of the Caledon Co., and the directors must also pay the costs of this application, save so far as same has been increased by the application to make the auditor liable, and I will refer all these costs to the taxing master to tax and segregate accordingly.'

MARITIME INSURANCE CO. LTD. *v.* WILLIAM FORTUNE & SON*
(Decided by ROCHE, J., in the King's Bench Division on 13th, 14th, 15th and 16th October, 1931)

Action against accountants—Alleged negligence in certifying accounts—Claim for damages—Scope of employment of accountants—No breach of duty

In this action the plaintiffs, the Maritime Insurance Co. Ltd., of Liverpool, claimed from the defendants, Messrs. William Fortune & Son, chartered accountants, of West Hartlepool, £522 damages for alleged breach of duty in certifying the accounts of the West Hartlepool branch of the plaintiff company, and failing to discover defalcations amounting to over £500 carried out by an employee. The defendants denied negligence and pleaded that they were not employed as auditors, but only to see that certain monthly returns were correctly made out from the books kept by the company's servant.

Mr. C. F. Lowenthal, K.C., and Mr. C. B. Fenwick appeared for the plaintiffs; Mr. N. L. C. Macaskie, K.C., and Mr. J. Charlesworth for the defendants.

The case was opened at the Newcastle Assizes on 11th November, 1930, and Mr. Lowenthal stated that the action had been brought for damages sustained due to alleged negligence in connection with the audit of the accounts of the West Hartlepool branch of the Maritime Insurance Co.; defendants, month by month, purported to examine the accounts of the branch and to deal with the statements and balance sheets prepared each month in regard to these accounts, and gave an unqualified statement that the accounts had been audited and examined by them and found correct. It was alleged that the accounts stated to have been audited had not been examined and that had matters been gone into properly, the irregularities would have been discovered.

Mr. Lowenthal, continuing, said the defendants denied that they were employed to examine the monthly returns made by the manager of the West Hartlepool branch, and to certify that the returns were correctly made out from the books kept by the manager. He submitted that they were employed, as chartered accountants, to see that the figures in the statements and balance sheets were in accordance with the figures in the books, whereas the cash balance sheet appeared never to have been verified. Messrs. Fortune & Son were paid 12 guineas per annum for the work.

There was no question, proceeded counsel, that the manager of the West Hartlepool branch (Mr. Audas), by a fraudulent system, had misappropriated sums amounting to £522 odd. That was admitted. It was also admitted in terms that these sums were irrecoverable from Mr. Audas, as he was now 'a man of straw'. The defendants themselves were employed to investigate the matter, and they eventually found the items.

Counsel went on to say that, when the list from West Hartlepool arrived at Liverpool, it was the duty of the accountant there to go through them, and if he had found that balances were very much overdue there would have been immediate inquiries at the local office.

The statement by Messrs. Fortune that the accounts were 'audited and found correct' should mean examined with the ledger. If they had examined them with the ledger they would have found time and again—he believed on 614 occasions—inconsistencies, and, what was of the greatest importance, that the dates on which these balances became due had been mis-stated in the lists sent to Liverpool.

Had they checked the accounts with the ledger, and given one or two examples of overdue dates which were being misrepresented, steps would have been taken,

* [1931] *The Accountant* L.R. 44.

and the whole of this business would have been suspected and stopped at once, just as if the cash balances had been found not to be correct, or if they had said 'audited and found correct subject to not having checked the cash balances, and we have not given you any differences between the monthly list dates and those in the ledger'.

Mr. Lowenthal said he did not wish to put too great a stress upon this point, but he did suggest that occasionally, in auditing and dealing with these accounts, they should occasionally have checked them with the ledger and the cash balance.

The judge: In other words you cannot ask much for one guinea a month.

Mr. Lowenthal: I don't want to say that.

The judge: I think you don't want to be too severe upon them. I suppose you mean that a guinea is supposed to represent half a day's work.

Counsel went on to suggest that he wished to make the point that at least some items should have been tested. 'They cannot say,' he went on, "'we took only a guinea a month", and not do the job properly. I am ready for your lordship to give every latitude which is right and fair, but if they had done this checking on only a few occasions they would have discovered that Audas was juggling with these books and pocketing the company's money. And I say the auditors were employed to prevent this happening by exercising only a superficial supervision.'

Matters came to a head, said Mr. Lowenthal, in March, 1929. Messrs. Rowland & Marwood, who did a good deal of business with the Maritime Insurance Co., had paid all their premiums and had had a number of claims credited by the head office at Liverpool, but these had not been paid and they were misrepresented in the monthly list of balances. The head office assumed that as the accounts had been audited and found correct, the claims had been credited against the premiums.

In March, 1929, a letter was received which caused inquiries to be made. Messrs. Fortune, said Mr. Lowenthal, were appointed to the work of auditors in 1900. Mr. Audas appeared to have looked upon the business done as his own, and that the premiums were due to him in the first instance and then to the company through him.

A letter was read by counsel for the Maritime Insurance Co. to Messrs. Fortune in which it was stated that 'the irregularities should have been apparent to yourselves as auditors of Mr. Audas's accounts and the company look to you to make good the loss'.

The defendants' solicitors replied that 'the irregularities owing to the defalcations of Mr. Audas could not possibly have been found out by our clients as auditors of the accounts', and they denied liability.

Evidence was given by Mr. Hy. Edward Stephens, secretary of the Maritime Insurance Co., who said that when their agent, Mr. Thos. Blenkinsop, died in 1919, they joined forces with the office of the Scottish Union and National Insurance Co., with whom they were associated, and who had a branch at West Hartlepool. Mr. Blenkinsop's clerk (Mr. Audas) was taken over, and Mr. Frederick James Carr, district officer of the Scottish Union, was manager of the office.

In reply to Mr. Macaskie, witness said that there was no agreement with Mr. Carr.

Answering the judge, witness said that letters were addressed to Mr. Carr and that he generally signed the letters from the West Hartlepool office. From time to time Mr. Carr talked matters over with Audas to see if they were still retaining the business of old clients, but he took no detail work in obtaining business or looking after premiums.

Continuing, witness said it was the duty of Audas to pay premiums received into the head office account at the bank. There was never any remark on the auditors' statement to indicate that the cash balances were not examined.

Mr. Alfred Cook, manager of Messrs. Milburn & Co. (Newcastle) Ltd., a Sunderland firm of ships' store merchants, deposed to paying Mr. Audas in cash on three distinct occasions at the West Hartlepool office in respect to premiums owed by his firm to the plaintiff company.

In reply to Mr. Macaskie, witness said that on one occasion Mr. Carr was in the office while he was paying cash to Mr. Audas. They talked together while Mr. Audas was away receipting the account.

Mr. Fred J. Carr said he had held for several years the position of local secretary for the Scottish Union and National Insurance Co. at West Hartlepool. In

October, 1919, he was appointed branch manager of the office in which the Maritime Insurance Co. carried on their business of marine insurance and the Scottish Union their business of general insurance; both were part-time appointments.

Mr. Lowenthal: When you took up your employment there as branch manager, did your work take you out of the office a great deal?

Witness: Practically the whole of my time was spent outside.

You were maintaining old connections in Hartlepool and West Hartlepool?

Yes, and endeavouring to obtain new ones.

Witness went on to say that he had not the slightest knowledge or experience of marine insurance, and he made it clear to the managing director of the company at the very outset that he could not deal with the marine insurance side of the administrative work. This was handled by Audas.

Cross-examined by Mr. Macaskie, witness repeated that when he took up the appointment he knew nothing about marine insurance.

Counsel: Were you ever intended to learn anything about it?

Witness: Yes.

And I suppose that in a few years' time you got to know all there was to know about the work of the branch?—In effect, yes.

You came on the scene in 1919?—Yes.

You were concerned with the outside work—that is obtaining marine insurance outside?—Yes.

Did you have anything to do with such business when it came into your office?—No.

Do you seriously suggest that you had nothing to do with any work connected with the marine insurance business in the West Hartlepool office?—I don't know that I should say that. My part was to get the business.

You are called the manager, are you not?—Yes.

And you had to manage the people under you, hadn't you?—Up to a point.

Hadn't you to manage Mr. Audas?—Up to a point.

What point?—Up to the point that I had to leave him to manage the office in view of my ignorance of the business. I couldn't very well turn round at that time and say that he was doing things wrong when I didn't know much about the business myself.

Do you mean to say that, after you had been there five years, you were not in a position to supervise what Mr. Audas was doing?—The point of the matter is that I hadn't time to do it.

Do you mean to say you had no time to supervise how he kept his books or how he prepared his monthly returns?—No, sir.

I put it to you that you were expected by the company to supervise Mr. Audas in the way he kept his books and in the way he prepared his monthly returns?—I am not aware that was so.

I suggest to you that when they had complaints to make about the way in which the monthly returns were made they invariably wrote to you and you invariably replied?—They wrote to the branch. They were open letters.

Did you sign the letters?—That is quite possible.

In further cross-examination counsel read correspondence between the head office and Mr. Carr, and suggested that the letters were instructions to Mr. Carr to make a more careful supervision of Mr. Audas.

Mr. Carr: I don't agree with that.

The case was adjourned.

In the King's Bench Division, 13th, 14th, 15th and 16th October, 1931

On the resumption of the case on 13th October, 1931, Mr. Lowenthal stated that the Maritime Insurance Co. had a branch office at West Hartlepool where the accounts were kept by Mr. Audas. It was his duty to send monthly returns to the head office in Liverpool showing the state of the accounts as between the branch and the head office and the amounts due from policy-holders as premiums and to policy-holders in settlement of claims. The defendants gave to these returns the cleanest certificate that he had ever seen in the course of his professional career. In fact not one of these returns and not one of these lists of balances accorded with the true facts. Comparison of the balances with the ledger would have shown discrepancies again and again during the thirty-seven months between

January, 1926, and January, 1929. There were in fact 614 inconsistencies between the ledger and the lists of open balances.

Of the ultimate deficiency of £522, £395 was on one account alone, that of Rowland & Marwood, steamship owners of Whithy, though in fact all their cheques passed through the company's banking account at West Hartlepool. In the three years they paid premiums amounting to £3,387. They were short credited to the extent of £395 and the money rendered available by this short credit was credited to other persons.

His lordship: Let's see if I understand the system pursued by Mr. Audas. Some of Rowland & Marwood's money is credited to other people. The other people had paid before and Mr. Audas had taken their money but he made it up in this way.

Mr. Lowenthal said that Rowland & Marwood had shown extraordinary patience in waiting for the settlement of claims allowed by the head office. Without seeking to impose on the defendants any very heavy burden, he submitted that they ought to have applied at least one of a number of tests which would have shown what was happening and it was their duty instead of giving the clean certificate, to put a note upon it which would have caused the head office to make earlier inquiries. Comparison with the ledger would have shown that the list of open balances did not coincide with the entries in innumerable instances. The cash book was kept in such a way as to show that it was not a contemporary record. It contained no dates and it was not even written up for the current month. Assuming that it was the duty of Messrs. Fortune to audit at all, the condition of the cash book threw upon the auditors still greater burden.

Either they could have counted the cash at the end of every month or they could have checked the application of the customers' cheques.

They did not count the cash and their reason was that they only came in to do their work in the middle of the month. In his submission that was a bad reason and it was their elementary duty in such circumstances to have payments in and out vouched since the end of the previous month. Without that they could not properly say that the returns had been examined and found correct.

He submitted also that they ought to have asked for information with regard to the cheques in the bank pass book. Examination of the counterfoil paying-in book would have shown that the credits to customers did not accord with the cheques received. The juggling with the account of Rowland & Marwood would have been disclosed instantly by such an examination.

Further, no vouchers were called for to show the cash and cheques received. Defendants' explanation of that was that the receipts and accounts were sent to the clients. He submitted that having regard to the condition of the cash book, it was negligent to grant a certificate without calling the attention of the head office to the fact that none of these things had been checked. They never even called attention to the condition of the cash book. If the Court held that the terms of the defendants' employment were such that they had in fact carried out their duties, it would make the employment of auditors and accountants a mere farce, but in his submission it was impossible even to take the view that they were not purporting to act as auditors in the ordinary sense.

Mr. Herbert McCulloch, chief accountant to the Maritime Insurance Co., said in evidence that before discovering the deficiency in the accounts of Mr. Audas, he went to West Hartlepool to arrange for an alteration in the system of checking. Messrs. Fortune's representative never suggested on that occasion that they were not auditors and until this action was started, he had not heard any suggestion of a limitation of their duties.

'Do any one of the lists of open balances,' inquired Mr. Lowenthal, 'between January, 1926, and January, 1929, truly show the amount of the open balances on the dates on which they were alleged to be open?'

Witness: No.

Mr. McCulloch, proceeding, said that examination of the cash book, the ledger and the counterfoil paying-in slip book would have demonstrated that it was not possible to say the lists of open balances were correct.

Cross-examined, he thought that with ordinary diligence Messrs. Fortune could have discovered the defalcations of Mr. Audas from these books. They had access to more documents than head office.

'Don't you think,' said Mr. Macaskie, 'that your system at head office was a little lacking?'—No. Proceeding, witness said that if Messrs. Fortune had looked at the paying-in slip book they would have seen the amount received, and examination of the ledger or other books would have shown whether that was the amount of premiums due or the amount of premiums less something for claims settled.

Mr. Macaskie: Have you ever heard of an auditor looking at a counterfoil paying-in book in the ordinary discharge of his audit?—Not if he can find another check.

Have you yourself ever known of a case of an audit being conducted by an auditor resorting to a counterfoil paying-in book?—On one occasion; it was a tennis club account.

Do you think Mr. Fortune exaggerates when he says it has never been suggested in the course of carrying out of the duties of an auditor that the counterfoil paying-in book should be checked for the purpose of auditing the cash book?

His lordship: I cannot understand that. It is the first thing the common-sense man looks at if he does not understand the pass book.

Mr. McCulloch said that he went to the West Hartlepool office in 1929 and Mr. Audas confessed to the deficiency.

His lordship: You did not have to find it out from the books yourself?—No, my lord. He told me he had taken the cash and it had been going on for some time.

His lordship: Compared with your own business in Liverpool, would the West Hartlepool business be a one-hundredth part?—Less than that.

Mr. McCulloch suggested that instead of certifying the accounts as 'examined and found correct', Messrs. Fortune should have certified them as 'in accordance with the books' if their view of their duties was correct. He did not know what Messrs. Fortune were told they would be expected to do when they were originally engaged. He did know that they agreed to conduct this monthly investigation for a fee of one guinea a month.

Mr. Macaskie: A somewhat modest fee for what you say was a strict audit?—Not in my opinion.

Don't you agree that if this were intended to be a strict audit and not the check we say Messrs. Fortune were employed to carry out, the transcript of orders and settlement of claims and returns which you had at head office would have been sent to Messrs. Fortune for them to check with the books at the branch?—No.

Don't you think one thing these gentlemen should have been warned about was the extraordinary position of responsibility in which Mr. Audas was put?—Mr. Audas was always in that position.

I suggest to you that the head office had all the material for carrying out an audit themselves?—No.

For the defence, evidence was given by John C. Fortune, F.C.A., senior partner in William Fortune & Son. He said that this work was first undertaken in 1900 when the Hartlepool business was an agency and not a branch. At that time his father was the head of W. Fortune & Son. What they were told was that the monthly returns were unsatisfactory and the Maritime Co. wanted to see that they came forward in better form and more regularly. The form was prescribed by the Maritime Co. and what Fortune & Son had to do was to see that the facts and figures stated were based on entries in the books. At no time were they asked to do more than check the returns by the set of books shown to them in the office. It was usual to check the cash book with the pass book. Except in an investigation when there was reason to believe that something was or might be wrong, the cash book was never checked with the paying-in book.

Cross-examined, Mr. Fortune said anybody could have done the work which his firm was employed to do, although there was much more of it when it was started. If the books were written up, his firm's job was to see that they were properly transcribed.

His lordship: Do you mean that if you found that the books were balanced by error you had not to call anybody's attention to that?—We had not. Proceeding, witness said that the state of the cash book did not prevent them from checking the cash in the middle of the month but the balances shown were very trifling—between £25 and £50—inasmuch as there was other cash besides Maritime cash in the office, it would have served no useful purpose to have asked for production of it because the amount could very easily have been produced. If they had been

auditors in the ordinary sense, they would have considered the cash position and have reported to head office that there was mixed cash and asked if the head office wanted them to do their best to trace it.

Mr. John C. Fortune, continuing his evidence under cross-examination by Mr. Lowenthal, K.C., for the plaintiffs, said that so long as the books contained nothing suspicious, all his firm had to do was to see that the returns made by Mr. Audas to head office coincided with the entries in the books.

Mr. Lowenthal: That is something new. If you put that upon me I cannot treat you with the respect I would wish.

His lordship: A man cannot be morally blamed because he thinks better of what he has said.

Mr. Cyril Charles Akers, partner in William Fortune & Son, said that he personally went to the West Hartlepool branch of the insurance company to do this work two or three times a year. Though the cash book was not written up from day to day, he saw nothing in that to arouse his suspicion.

JUDGMENT

ROCHE, J., giving judgment, said this case was made the more difficult because of the fact that the employment of the defendants, upon which a great deal turned, started more than thirty years ago. There were three matters to be considered: (1) What was the scope of the employment. (2) Did the defendants perform their duties or were they guilty of negligence. (3) Was the loss sustained by the plaintiffs the result of acts or omissions of Messrs. Fortune. What happened was that there was in the employment of the West Hartlepool branch a Mr. Audas, a man who was no doubt up to a point of a very real respectability and who was esteemed and trusted by all who knew him. Unfortunately, for some years before 1929, he permitted himself to use his employers' money as if it was his own and he covered his misdealings by omitting to enter in the books of account the receipt of considerable sums in cash and cheques. The question was whether the employment and duties of Messrs. Fortune & Son were such that they ought to have found out what Audas was doing.

Two competing views as to the duties of Messrs. Fortune & Son had been put before the Court. He thought that their duty was not to conduct what might be called a full audit nor was it simply to see that what appeared in the books was correctly stated or summarised in the monthly returns. Messrs. Fortune were appointed at the time when the branch was an agency and the books of the agency were in some confusion, although no suggestion was made against the honesty of the then agent. With the advice of the insurance company's accountant, there was a reorganisation and it was arranged that certain books of account should be kept and certain returns made to the head office to summarise the result of the entries in these books. In his view, the employment of Messrs. Fortune & Son was limited to examining the books, seeing that they corresponded with the books that had to be kept and in that sense seeing that they were adequately kept and seeing that they were adequately summarised in the return to the head office. Of course, it would have been the duty of Messrs. Fortune to report on the matter if anything suspicious had appeared in the books. In his view there was nothing which excited or ought to have excited their suspicion. They were not in possession of material which would have enabled them to know whether the business of the branch was being satisfactorily conducted or whether the books of account truly showed the state of affairs of the branch. He thought that the misappropriation of money was not detected before it was, because there was no system in vogue by which the cash received could be checked. The acts and omissions which brought about the trouble were not the acts and omissions of Messrs. Fortune & Son, and they had been guilty of no breach of duty or negligence.

The counting of the cash would have been useless in the circumstances and there was nothing which required them to go behind the books of account and examine the paying-in book. That was only done in cases where there was reason to suspect inaccuracy or dishonesty and Messrs. Fortune had no reason to suspect that here.

Judgment was accordingly entered for the defendants with costs.

REX v. LORD KYLSANT AND ANOTHER*

(Trial at the Old Bailey, 20th to 30th July, 1931, before Mr. Justice Wright and a jury)

Extracts from Mr. Justice Wright's charge to the jury

Note.—The facts are briefly narrated in the text of this work.

A great deal has been said about the keeping of secret reserves, and how far that is or is not permissible under the Companies Acts or under the special charter of the Royal Mail Steam Packet Company, because, as you will remember, the questions which arise here fall to be decided, so far as that aspect of the matter is for your decision or your consideration at all, under the special charter of that company. We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. We have heard a great deal about what is often done in practice, and it may be reasonably and properly done, but the question may arise some day, and possibly will arise, in some appropriate proceeding in order to find out and elucidate these very special matters. It was said by a very learned judge on one occasion, by way of observation and not by judgment, that a company, that is to say the shareholders, could not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of the companies, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, have very large portions of the company's assets left in the secret disposition of the managing authority. It may work very well in many cases; no doubt it does. It is a practice which is being followed, no doubt, by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities, and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it at all? How can they consider whether it is something which they are satisfied with or which they are not satisfied with? Taking this case, without entering into the thorny question as to whether you have here anything which can be called reserves or not, you have here a large sum of money, or perhaps a series of large sums of money, the nature of which and the propriety of which has remained a secret from the shareholders, and the use of which has remained a secret from the shareholders, if you exclude certain things which appeared in the three last balance sheets with which we are concerned. What has happened as a result of that? We know that there were balance sheets and profit and loss accounts published for a period of seven years which did not disclose one way or the other whether the company was earning any profit or not, and during those seven years there was expended out of those items, which were mainly connected with the war, a sum of no less than five million pounds—not out of current earnings at all, but out of those items which, in the main, arose out of the war; and during all that period the shareholders were told nothing, and they drew their dividends presumably in the simple faith that all was well with the condition of the company. It is said: 'Very well, they got their dividends. Times might have changed, and although these items of income came to an end others might have taken their place and conditions might have improved'. But, on the other hand, surely if the shareholders had been told (I do not say who is responsible for the moment) that this company had no earnings—because earnings are the life blood of a company, and a company cannot go on indefinitely using its capital assets unless it is earning—if they had been told that this company had no earnings, surely they might have taken steps, as could be done, and as has been done in other cases, for the reconstruction and rearrangement of the company's affairs, the cutting down of expenditure, the reduction of services, and all those things that have to be done when a company is not paying its way. The sooner

* [1932] 1 K.B. 442; 75 *The Accountant* L.R. 55.

that is done the better, and the better hope there is of the company surviving the troublous times. I will say something about what appeared on the profit and loss account a little later. It was never brought to the shareholders' knowledge what the position was. It may seem incredible that this could go on in a big company for all those years, but so it was, and then eventually, at a period which is outside the period we are concerned with, something had to be done and some steps had to be taken. It is a little astounding, and one cannot help wondering whether those who manage big companies do not forget sometimes that the body of directors of a company are the agents and the trustees of the shareholders, that they owe them full information, subject to proper and reasonable commercial necessity, and it is their interests that they have to study. They are not to regard shareholders as sheep, who may look up if they are not fed; they are the people whose money they are using, and it is to be remembered that a joint-stock company is a creation of law. A joint-stock company has the enormous advantage of limited liability, and the legislature has intended, it seems to me, although by halting steps, to secure that those who enjoy those privileges of limited liability and who control and manage joint-stock companies should be subject to some condition as to publishing their accounts, at least to the shareholders and at least to those who are entitled to be summoned to general meetings.

The law has recently been altered in the Act of 1929, and for the first time that has provided for the sending to shareholders of a balance sheet, and a profit and loss account in every year; and there are penalties imposed upon directors who do not do that. The balance sheet must contain a summary, among other things, of the liabilities and assets together with such particulars as are necessary to disclose the general nature of the liabilities and assets of the company, and to distinguish between the amounts respectively of the fixed assets and the floating assets, and state how the values of the fixed assets have been arrived at. It further provides that there is to be a report by the directors with respect to the state of the company's affairs, and the amount, if any, which they propose to carry to the reserve fund, or any other reserve. It may be said that that does not in terms prohibit the creation of any reserve which is not shown specifically on the balance sheet, and it may be said that in a matter of domestic concern like the keeping of reserves by appropriate regulations the shareholders may agree to a reserve being accumulated, the exact amount of which is not specified in the balance sheet or the profit and loss account. That is a question which, no doubt, will require very careful consideration in some future case, but it does appear to me, as at present advised, that the terms of the sections which I have read cannot possibly justify the omission of any amount of any reserve from the balance sheet and the profit and loss account altogether. There may be some justification for the maintenance of an undisclosed or secret reserve, if the fact that there was such a reserve was clearly specified somewhere in the report, so that the shareholders could know, and if the majority of them desired to insist on its disclosure and its utilisation they could do so. However that may be, it is clearly the intention of these sections that the accounts of companies in future should be published with greater particularity and with greater information to the shareholders.

Then there is the question of the auditor, because, as you will remember, the law requires the appointment of an auditor, who is the servant of the company, and his duty is to report to the shareholders, on proper examination, on the accounts which the directors are going to present to the company. The law does not impose an impossible burden on auditors; it does not make them insurers; it does not require of them skill and vigilance which is beyond their power; but it does require them to report, and to report on the accounts would certainly include a very careful investigation of the profit and loss account as one of the accounts, even if it is not expressly covered in the certificate which is generally accepted as a complete report. Then they have to give a certificate as to whether in their opinion the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the

best of their information and the explanations given to them. Now, if the account on which the dividends are being paid, or if the account on which the current expenses of the company are being met, is being fed by undisclosed reserves, it seems to me very difficult to see how the auditor can discharge his duty of giving a true and correct view of the state of the company's affairs without mentioning and drawing attention to this fact, which may be of the most vital importance, as indicating the state of the company's affairs. No doubt an auditor, in his very delicate and difficult duties, must use a certain amount of discretion, but, whatever discretion he may feel that he is justified in exercising within the limits of what is reasonable, he must remember that he is under a statutory duty, and that he may come under the penalties of the law if he fails in that duty, at least in specific ways which I need not trouble about at this moment.

An auditor is not concerned with questions of policy, and it is not for him to say whether a dividend is properly or improperly declared, but, if he sees on the accounts there is something in the accounts to which he ought to draw the attention of the shareholders, it is his duty to do so, and either he should not sign the certificate at all or he should sign it with some qualification such as the circumstances require.

That being the state of things, the question to be decided by you in this case is not whether the two defendants, or either of them, have committed any breach of their duty to the company, either as chairman or as auditor. If there has been any breach of duty, not negligence, but anything for which the directors or the auditor may be liable to the company, that is a matter entirely beyond your purview or beyond your consideration. You are not here dealing with questions of civil liability. For civil liability the appropriate remedy is an action for damages; but when a matter comes before this Court it comes as a matter of criminal liability; it comes before this Court because there has been some infringement of the law which goes beyond the purview of civil liability, which is merely answered in damages, and which amounts to a crime against the State, of which the State must take cognisance, and a crime for which the party who is convicted must receive a sentence appropriate to a criminal.

Now I think it would be convenient for me to read to you Section 84 of the Larceny Act, 1861, which deals with publishing fraudulent statements. It says: 'Whosoever, being a director, manager, or public officer' (**public officer would include the auditor**) 'of any body corporate or public company, shall make, circulate, or publish, or concur in making, circulating, or publishing any written statement or account which he shall know to be false in any material particular with intent to deceive or defraud any member, shareholder, or creditor of such body'—that is the first matter we are concerned with on the account. Then it goes on to say something which is not material, and then it says: 'or to entrust', that is to say, with intent—'to entrust or advance any property to such body corporate, or public company, or to enter into any security for the benefit thereof, shall be guilty of a misdemeanour.' That is the section. It seems to me, as Acts of Parliament go, to be reasonably clear and not to require any particular exposition, except that I want to emphasise certain aspects of it, and I want to state what is the construction I have arrived at on a point which may be important. A point has been raised or adumbrated as to the meaning of certain words. These are the words which it is said require some consideration, and I confess I think they do. It is these words: 'make, circulate, publish, or concur in making, circulating, or publishing any report, statement, or account which he shall know to be false in any material particular'. What exactly does that mean? The conclusion I have arrived at is this, that it is not limited to a case where you point to a written account or written statement and say: Here are certain figures; here are certain words which are false. I think that is too narrow unduly the words 'in any material particular'. It is perfectly true that in a criminal act, which carries with it the penalties of the criminal law, the Act must be strictly construed, but it must be reasonably construed, and in my judgment to construe it in that way would be to shut out a type of fraud in connection with written documents or written accounts which may be of the utmost importance, and that is the type of fraud which may be found in a document, not fraudulent in the sense of what it states, but in the sense of what it conceals or omits. It may be said that you

cannot put your finger on any actual statement and say it is false in a material particular, but I think the language which is used means more than that, according to its reasonable interpretation. It will cover the case where you have a written statement which is false, not in any specific words or any specific figures which it contains, but which is false in the way in which a document may be fraudulent, namely, where you may take every word and every figure, and say, 'Now, there is nothing false about this; there is nothing false about that', but the document as a whole may be false, not because of what it states, but because of what it does not state, because of what it implies. Of course, that type of falsity, which is indeed the type of falsity in the main question here, is more difficult to establish than the case where you can point to a specific false word in a sentence, because where the falsity consists in a fraudulent desire to create a false impression, while keeping accurately to the limited facts which appear in the document, you have to show affirmatively that there was a deliberate intent to create a false impression. If you have a definite falsehood, that speaks for itself. A man who has told a definite falsehood or written a definite falsehood may perfectly well be able to show that, though it was false, he did not know it was false, or in certain cases, though he knew it was false, he did not intend to deceive anybody, but made a false statement, an inaccurate statement, thinking that it was substantially true, though he knew all the facts which ought to have told him it was untrue. That is a much simpler case than where you have a case in which a written statement is alleged to have been false in the sense that it was concealing the true facts. Then you have to show before you can get any further at all that it was a deliberately concocted instrument, the instrument of a definite scheme to defraud or to deceive, as the case may be, and, therefore, in order to prove a case of fraud of this latter type, fraud as it were by concealment, the intent of the parties must be established at the outset. But to construe Section 84 so as to exclude from its ambit that type of fraud in a written statement of account is, in my judgment, to limit unduly the scope of the enactment, to exclude from it some of the most important types of false documents which in this class of case may have to be dealt with. The language must be construed reasonably, according to its natural meaning, and in my view, having regard to the whole of this section, its purpose and its character, I think the construction which I have given to it is the true construction. I have to decide this myself and you must take that view of the section from me. Of course, if I am wrong and the necessity arises hereafter, there are other Courts who can deal with the matter. My duty is to decide to the best of my judgment, and that, in my view, is the construction.

Now, as you see, the section involves three things, a false written document, knowledge of the falsity—that means the recognition, the understanding, the realisation of the falsity by the person who publishes it and puts it forward—and, thirdly, the intent to deceive. The intent to deceive is a quite separate thing. You may have the first two steps; you may have a false document, and you may have it published knowingly, and yet there may not be circumstances which justify you in finding that there was an attempt to deceive. In fact, in one of the sections of the new Act—I think it was also in one of the earlier Companies Acts—you have the offence, the misdemeanor, of publishing a false document knowing it to be false, but with no reference to the intent to deceive, which is left out, just as in some other criminal offences of a more obvious character the intent is not a necessary ingredient. But here the intent to deceive is a necessary ingredient as regards the accounts to deceive shareholders, and as regards the prospectus to deceive possible investors, if I may compendiously explain the position. The intent must be established, because if a man publishes a false statement knowingly it may be that, *prima facie*, he has an intent to deceive the person to whom it is published; but that is only *prima facie*, and I am not considering any question of the burden of proof here, because it seldom arises in criminal cases. But it may always be shown, and the jury are always entitled to find, that though there was a false statement published knowingly, the intent was absent, just as where you may have a case which is *prima facie* murder, but the accused man, though he did the act, might show that the relevant intent was absent. Then, of course, he cannot be found guilty of murder. If he is found guilty at all it is of some minor, alternative offence which is open to the jury.

Just before I leave these general considerations I might remind you again that

you are dealing with questions of criminal intent. Sir John Simon read a passage in a famous summing-up in one of the early cases under the section, and, though I think I have said in effect what is stated there, it is most admirably put, and I should like to read it to you. The Chief Justice of those days said: 'In a case of this kind we are, as it were, upon the very confines which separate civil and criminal law, and we must take care that we do not overstep the boundary line. It is one thing that a man may make himself liable to an action, or may be liable to have a contract which he seeks to enforce held to be vicious and bad, because he had stated something which went beyond the exact line of truth, or has concealed some material facts which ought to have been made known to the other contracting party. More than this is required to support this charge. A man may honestly misrepresent, that is to say, he may state as true something which he believes to be true, and which turns out to be untrue. If he has given a warranty, or has entered into a civil contract founded on the assumption of the fact in question, he may be liable in a civil action to be defeated, but that would not be sufficient for the present purpose. Here you must be satisfied that that which is alleged to have been misrepresented was known to the defendants to be false, and that, acting upon that knowledge, and with the deliberate intention to deceive and defraud, they did that which is alleged to have constituted the criminal offence for which they are now put on trial.'

I think probably I have only been repeating what you have heard during the last ten days, but it is my duty to repeat it and to repeat it with all the solemnity of which I am capable in the course of this summing-up.

The period in question which you have to consider is from 1921 to 1927, or more specifically you have to consider the two years 1926 and 1927, when you are considering the counts, because it is to those two years that the specific accounts in the indictment refer. I have already said that you are not concerned with any question of civil duty as between the company and the two defendants, or either of them. In saying that, may I remind you of what the case actually is which is put forward by the Crown? For this purpose they do not lay any stress on the precise rules of law as to the completeness of a company's accounts, or the accounts of this company, or the precise duties of an accountant. What they say is: Assume that, as the practice is said to be general, the directors may be justified in putting money to undisclosed or secret reserves. Assume that they may use these secret reserves without telling the shareholders for some period of time, and do that properly. Assume all that, yet a time must come when, if that is done to a large extent, with large sums of money, or if it is done over a long period of time, you have then a circumstance so vitally affecting the life of the company, and vitally affecting the interests of the shareholders, that any deliberate concealment of those circumstances is a breach of duty on the part of the directors or auditors, and, if done fraudulently, with intent to deceive, constitutes an offence against the State. **I do not gather now that there is any real question as to the general accuracy of the view that a very heavy or a very long, protracted utilisation of secret reserves, in order to keep the company going, is a serious matter which, quite apart from anything I have said about the general law, ought to be disclosed, on any view of the position, to the company.**

You have had the benefit of hearing the evidence of that very distinguished accountant, Lord Plender. There was a question put by Sir Patrick Hastings. Lord Plender is a little guarded in what he said: He was asked: 'Q. There are such cases, that is to say, cases where there is no longer a requirement to keep a reserve for excess profits duty, that is introduced into the credit of the year's profit and loss, and no mention is made on that occasion that reserves have been called upon?' Lord Plender said: 'There are such cases.' Then I put a question: 'Q. You mean that has been done?—A. It has been done.' 'Q. So far you express no view about it?—A. It is done by firms of the very highest repute.' Then he is asked if any exception could be taken to that, and he says: 'As a principle no exception could be taken.' He was definitely guarded. Then he was asked: 'Q. There would come a time when the auditor would say: "Now, if these reserves are to be used again, some indication must be given to the shareholders that the profit and loss account is augmented by transfers from the excess profits duty or other reserves"?—A. Yes.'

Then there is a question as to what phrase is the proper one to use. There is a

phrase, which may be very familiar to you, but as far as I know is not suggested as being familiar to anybody but accountants. I do not know how that may be. There is the question whether the addition of those words in the balance sheet in the year 1926, 'Adjustment of taxation reserves', was, in all the circumstances of the case, a proper method of illuminating the minds of the shareholders as to what was actually happening. That is a question which you will have to consider and on which you will have to give a decision one way or the other. Is this phrase 'Adjustment of taxation reserves' a proper intimation to the shareholders in 1926 of what has been going on in the company's affairs, in order to produce year by year not only the debenture interest and the interest, discounts, and other things, but the preference dividends and the ordinary dividends? I am going to say a word about the facts in a moment, but at present I am reminding you—although I am sure you have it all present to your mind—of what appears to me to be the first question you have to consider. Granted all this, was it false and misleading in all the circumstances to put forward to the shareholders in the balance sheets in those years merely these words 'adjustment of taxation reserves' as a warning that these enormous sums were being drawn from these funds, the nature of which I must consider a little later?

Lord Kysant was asked about this matter. Perhaps before I turn to his evidence I may refer to the evidence of Mr. Hill. He was asked in cross-examination: 'Q. You agree with me from the accountants' point of view this matter is a matter of degree?—A. Exactly.' That is the matter of transferring sums from reserves without disclosing them. Then he was asked: 'Q. Whether you are right or wrong in law, we are not debating in this case, because, as I say, this is not the proper arena, but in fact transfers from a reserve fund are sometimes brought into profit and loss account without any notification of it at all?—A. That is so. Q. Then there comes a stage whether as Mr. Morland said, it reached a matter of time or by the size of the amount—there comes a stage when some indication must be given?—A. Yes, some indication. Q. Some indication. Does there finally come a stage when there must not merely be an indication, but a perfectly precise phraseology when nobody can make a mistake about it?—A. I should think so. It depends on the circumstances; one cannot generalise exactly.' So that Mr. Hill, the President of the Institute of Chartered Accountants, says there does come a stage when some indication must be given and he would think there came a stage when a perfectly precise phraseology that nobody could mistake ought to be used, though he does not want to generalise.

That being, as it were, the starting point of the inquiry, what are the facts which you have to consider? The facts have taken a great deal of time to elicit, but I am not sure, now that we have got to the end of this inquiry, that there is very much mystery or very much complication. The broad outline is quite clear, and there does not seem, so far as I have followed the evidence, to be much difficulty. Of course, you are the judges of the evidence; you have heard it all. So far as I have been able to follow, there is no doubt at all that during those years, 1921 to 1927, the company was not earning any profits. It was both a shipowning company and a holding company, and therefore profits might come to it in two ways; they might come to it in the form of a balance of earnings over expenses in running its own ships, or it might earn profits from the fact that dividends came to it from various concerns in which it held shares. In the case of six companies it held all the shares. I do not remember their names, but I shall say a word about them in a moment. In a number of cases, as a matter of fact in thirty subsidiary companies, it held in some cases a controlling interest, and in other cases shares, and in those cases, in so far as they paid a dividend, it derived a certain income; but after bringing these into account, and bringing in the general result of the shipowning business, there was generally a deficit—not always. Then you have this position; that the company, although it paid its debentures, and although it paid its preference shareholders and ordinary shareholders, and did so without a murmur of complaint, except a general reflection on the hardness of the times, was all the time drawing sums which, in the end, in the aggregate over seven years, amounted to £5,000,000, and it was disbursed in that way. As you remember, the preference shareholders and the ordinary shareholders had 5 per cent., which amounted to, very roughly, £700,000 a year gross. It has to be borne in mind that these dividends and interest were paid after deduction of income-tax, and the

more dividend the company paid the better off it was at once, because whereas it paid its shareholders without deduction of income-tax it was able to keep the income-tax itself, and, therefore, during all these years in which these dividends, so called, were being paid, you had a regular yearly credit which was put in the books to what is called income-tax reserve, which was simply the amount of the income-tax on the dividends and interest paid, and, as you know, it kept that because it was not bound to pay it to the shareholders, nor was it bound to account for it to the Government. That, as I follow it, was in the main the constitution of one of these accounts we have heard a great deal about, which was called in the books the income-tax reserve. That account contained some minor credits, or some credits of this nature, credits for refund of income-tax which had been paid in earlier years and paid in excess of assessment on profits and when the actual profits were ascertained it was found that the assessment was excessive, and, therefore, sums were repaid back. That was under Section 34 of one of the Income Tax Acts. Then out of that fund, the income-tax reserve, there were some other payments in the nature of repayments in connection with excess profits duty. That was one main line of credit in the books of the company, and that was a credit in the main, which was a form of credit which was abnormal in this sense, that it only applied if and to the extent that the company was not liable to pay income-tax to the authorities because it was making no profits; but meanwhile it was paying these sums either to debenture-holders or to the shareholders. There were, however, other sources from which these heavy payments were made—I mean other than actual earnings or profits of the company—and the main of these is what is called excess profits duty reserve. I made a short statement about that, and I think you have yourselves exhibit No. 117, which sets out very conveniently the whole of this history, and, so far as I know, sets out accurately the whole of the history of these excess profits duties. It was put in by Mr. Manning, and he summarises it in this way. You will remember what the excess profits duty was. I say you will remember it, but, anyhow, it had been explained so often that I need not explain it again. When the war came to an end, and the period of excess profits duty came to an end, the position had to be considered, because there were very many questions of great difficulty which had to be determined. The course which this company had adopted during the war years was to lay by year by year a sum of money in anticipation of what they had to pay and, finally, I think the main reservation of these funds took place, but the actual process does not matter, because, finally, in 1921 in the books of the company they had put down as provision for excess profits duty during the whole period in which it was payable, ending in 1921, a sum of £2,260,600, and in fact there was paid over to the Revenue for the period with which we are concerned—I think the last payment was in 1921—a sum of £1,148,155, and, therefore, they kept in hand a difference of something like £1,100,000.

Now, there were considerable difficulties, as I have said, in ascertaining the precise amount, and there were considerable difficulties in appropriating to each year the proper amount even if it was otherwise ascertained, because the duties differed in different years. But by 1923, as I follow Mr. Manning's evidence, it was pretty well known what the ultimate liabilities would be, although in fact the ultimate liability was never definitely ascertained until May of 1927; but as it was fairly well realised, and, indeed, as it turned out, in that respect correctly so, the company it was said was justified in drawing from time to time or transferring to profit and loss from time to time the sums which in that way had been put aside, and these sums fell into two categories, a category of moneys actually paid, and a category of moneys kept in hand. There was a further complication which was not disposed of until 1926, and it was that the Government allowed in respect of the war period large sums to shipping companies such as the Royal Mail Steam Packet Co. under two heads, one called obsolescence, and the other called deferred repairs. You know what was meant by that, and I will not repeat it; and when they were settled in 1926 they were settled at a total of £1,428,705. Then when the excess profits duty was settled, it was settled at £1,769,122, and, therefore, when these two sums were set off one against the other, the final liability against the allowances for obsolescence and deferred repairs, the balance remaining was £340,000 odd. Now, that being the general position, I will ignore the constructive settlement in 1926 when no cash passed. That was ignored by Mr. Matthews when

he made up his accounts, and, therefore, what you have to deal with for this purpose is first of all the balance of the money which the company never paid over to the Government at all, and of that they felt entitled to use, and did use, the sum of £400,000 in 1922. In 1921 they transferred £300,000 by writing it off investments, and in 1922 they transferred £100,000 to profit and loss. In addition to that, they did receive from time to time from the Government various payments until the Government had repaid them, as they did in 1927, the total amount that the Government had received in excess of £340,000. These matters are set out very clearly in the table. In 1923 they received from the Government £250,000 and transferred to profit and loss the amount of £100,000. In 1924 they received a further £390,000 and transferred to profit and loss £330,000. That left, as you see, a substantial balance, which appears in the accounts to the credit of the fund. Then in 1925 they received nothing, but they paid over £300,000 because certain claims were either actually settled or in process of being settled. In 1926 they received £270,000 from the Government, that is to say, on account of this fund, and then the account being considerably in credit they transferred to the profit and loss £550,000. In 1927 the fund was finally closed up, and at the final closing up there stood to the credit of the fund £232,788. So that in all these years there was available on this account £1,912,788, and no part of that money was money earned during the period in question. It represented in one sense, though perhaps not technically, moneys which had been appropriated during the war period. It may be I am a little in error as regards 1921—I will refer to that in a moment—because there was paid over in 1921 to the Treasury in respect of excess profits duty £125,000. This is part of the first item paid to the Revenue. That was not earned in 1921, but the payment was made then. There has been a great debate as to whether it is to be regarded as reserves or not, and that is a matter on which Sir William M'Lintock was severely taken to account; but everybody always called it reserves, and for the purposes of this case—I do not know what you think—it does not seem to me to matter what you call them; they were in fact not current earnings; and as Sir William said: 'All I was looking after was what were the current earnings, and these were not current earnings; I noticed the amounts because I had noticed that they appeared in the profit and loss account, but they were not moneys which were earned in the period before 1921.' It may be, of course, that they were not available for use except at the time when they were actually used. Mr. Matthews says he kept it because he kept this fund, and he had an idea from time to time how much he was to release to profit and loss account, and he indicated that to Mr. Cason, and Mr. Cason, as we shall see later, apparently conveyed that to Lord Kyslant. But they were, as you see, certainly not current earnings, and they were no criterion of the earning capacity of the company at all in the period in question; and it is a fact that, whether they are called reserves or not, you will have to consider whether these sums of money are not, for the purpose of the question you are considering, just as if they had been reserves, although they were, as you see from this account, from time to time becoming available for use. **Then you will consider this question, whether the essence of the matter is simply this, that the shareholders ought to have been told that the company was being kept going by means other than current earnings.**

Now, as I say, you are concerned with those two years, 1926 and 1927, specifically, and you will remember that the balance sheet was duly signed year by year by Lord Kyslant as chairman and there is some evidence illustrating the manner in which the policy of paying dividends and dealing with the funds of the company was considered between himself and Mr. Cason. You will remember there was a document produced which you had in the exhibits—Exhibit No. 6—called 'Estimate for 1926'. It is a document which was produced by Mr. Cason, and, as I mention Mr. Cason, I may say, in passing, that he seems to have been an extraordinarily careful and conscientious official—one of those officials on whom the success or even the existence of these big concerns depends, with a very long-established service in the company, where he was the chief accountant for a good many years, and he produced these documents which he said he made for Lord Kyslant. As I understand it, the question was, what funds could be provided to pay a dividend on the ordinary shares of 4 per cent. in view of the actual financial position of the company? And this account was prepared and discussed.

It shows the debenture interest, the preference dividends, the insurance account of 3 per cent., which, so far as one can judge from Exhibit No. 21, was somewhat excessive, depreciation of fleet, interest and discount, and it shows a total amount wanted of £1,476,500. It shows voyage accounts, receipts, less expenses, £265,000, that is budgeting for a profit, not after depreciation, because depreciation, as you see, appears on the other side of the account but apparently after not only the various running expenses, which would figure in a voyage account, but all those general administration expenses which ought to come off the earnings. Then it says: 'Sundry receipts, including interest on investments', and that appears to be rather excessive. And it shows on that basis a deficit before any provision for ordinary dividend at all of £1,100,000. The problem which was being discussed was where to get the money from, or the credits from, for that purpose. It was suggested, as appears here, that the unpublished reserves—these are items which we have been discussing and which appear in Exhibit No. 21—were £600,000; they were to be drawn on to that extent. Insurance premiums were to be £100,000 carried forward, and then there was investment depreciation reserve £300,000. To make up the £1,300,000, it was proposed that the bonus shares from Nelsons, which were afterwards dealt with in the following year, should be brought into the account. The £600,000 was to be made from the unpublished reserves in this way: Income-tax reserves were to contribute £160,000, eventually they contributed £175,000; excess profits duty was to contribute £350,000—and that, as you know, was altered to £550,000—and it was decided not to take the bonus shares in that year. Then there were various other minor matters which do not appear to have been actually availed of when the accounts were finally made up. In that way, with the £600,000 and the other items, and the £200,000 bonus shares of Nelsons, it was intended to find sufficient credits or funds to pay the outgoings after depreciation.

That is the discussion which was relied on by the Crown as showing that Lord Kylsant was completely familiar with what was happening, and that he was seeing how he could provide the necessary funds in order to pay the various expenses and pay the ordinary dividends. The balance sheet for that, as you remember, was eventually published; it is part of Exhibit No. 1. You will remember I said you will not for a long time forget the appearance of these balance sheets. It shows in the balance sheet: Sundry balances, accounts not closed, and debts owing by the company, including loan from company, £2,842,440. Now, the make-up of that sum, though no doubt perfectly understandable by an accountant, is a little puzzling to the ordinary person, because there you have put together not only debts owing by the company but you have those credits which are constantly being called reserves and the exact nature of which you know, so that you have lumped together in one sum moneys held by the company and debts owing by the company, and, to make an observation which is true, so far as I understand, of every one of these accounts, no one reading these accounts, even if he could understand 'Accounts not closed', as meaning reserves, could tell how much was reserves and how much consisted of debts. However, that is true of all these various balance sheets, and it is not a point which is specifically complained of, although it has to be taken into consideration when you are determining, as you must determine, whether this balance sheet and profit and loss account is on the whole misleading and false or not.

Now, when you look at the balance sheet, bearing in mind exactly the position of the company, you find a balance for 1925, dividends paid in June, balance for the year, including dividend on shares in allied and other companies, adjustment of taxation reserves, less depreciation of fleet, £439,212, and there are various small items. You then find transferred from reserve fund £150,000, and you get the total £773,492, and that is expended in paying interest on debenture stock, interest and discount, dividends on the preference stock, surplus in favour of the company, proposed to be paid 4 per cent. on the ordinary stock, £200,000, and to be carried forward £66,000. That leaves a balance, and the account squares in that way. There you have the balance sheet which requires your consideration. You will remember that up to 1923 this balance sheet contained the words, 'Profits for the year', and then it was considered better to change it to 'Balance for the year', because, apparently, it was realised that truly there was no profit, if you merely look at the ordinary outgoings and incomings. It says: 'Balance for the year including dividend on shares in allied and other companies, adjustment of

taxation reserves, less depreciation of fleet, &c.' Whether the '&c.' refers to the 'less', or whether it refers to the positive items and not the negative items, is not worth considering, because I should think it clearly would read: 'Dividends, adjustment of taxation reserves, &c.', and the 'less depreciation of fleet' is a parenthesis. Looking at this document, in view of all those circumstances, you have to decide whether or not in your opinion it is a false document.

I am not going to repeat what I have already reminded you of, namely, that the time had come in 1926 when the state of the company was such that the company ought to have been informed either by the auditor or by the chairman that the concern was not paying its way apart from these special credits. For instance, as you see, £550,000 was taken from excess profits duty, and that was necessary in order to pay interest on the debentures, interest and discount, a total of £273,000, a further amount of dividend on preference stock of £233,000, and then dividend, interim and final, amounting to £350,000. It is perfectly true that it shows a transfer from the reserve fund, which would seem to indicate perhaps that it was the only, substantial use that was being made of the reserve, as, indeed, it was the only use that was being made of the published reserves, and it is perfectly true that you have these words 'adjustment of taxation reserves'. That is to say, the word 'reserves' occurs twice on this page, and that may be some sort of indication to anyone who understands the use of this language that to some extent other reserves than the published reserves were being drawn upon. On the other hand, it is pointed out that the amount drawn from taxation reserves which figures under the word 'Adjustment' is a very heavy amount indeed—£550,000—and it is said, in view of all the circumstances to make that anything but a misleading document, in view of the large amount drawn from reserves in proportion to all these other figures, that ought to have been clearly and specifically indicated, so that the true position of the company could have been disclosed to the shareholders; and that in view of the fact that it ought to have been disclosed, and that the accountant signed his certificate, which, may be, is only limited to the balance sheet, but which is generally understood to refer to the profit and loss account, which would be incorporated in the balance sheet—in view of the fact that he signed the certificate, it is said, and it is for you to consider, that that is not anything other than a written statement, false in a material respect, because it conceals the true position of the company in that year from the shareholders, who are entitled to be told, and to whom this report is addressed.

This seems to be the material in this aspect of the case relevant to 1926. In 1927 there is a similar exhibit—Exhibit No. 14. I do not think I have got the precise date for the moment on which that was discussed. It appears in Mr. Cason's evidence. I do not know that he gave the date. Anyhow, it was discussed at some time with reference to the 1927 figures, and that shows in a very similar way the arrangements that were being made, the provision which was being made to provide enough money to pay the debenture interest, the preference dividend, and to pay a dividend of 5 per cent. Of course, in a sense the debenture interest had to be paid, it was a first charge on the assets, but there were other questions, the question of paying a 5 per cent. dividend, and, in a less degree, the question of paying the preference dividend, in view of the circumstances that dividends are generally paid out of profits and ought to be paid out of profits. They may to some extent be paid out of a past profit stored by, but, in the main, dividends, it is anticipated, are being paid out of the profits, and in some degree it may appear that when you have a balance sheet showing, as you do, a 5 per cent. dividend, not for one year, but after a long sequence of years, and, indeed, rising to 5 per cent. after payment of 4 per cent. in a previous year—when you have those circumstances, and you have such a balance sheet and such a profit and loss account as you had, which is in terms just the same as for 1926—when you have those circumstances, again, it is said, that this is a false and misleading document. Of course, you have to consider that. I do not know that there is any other material on this point of the case that I can usefully refer to.

The next thing, of course, and the most vital and serious and important issue in this case, is the question whether, if you find that this was a false and misleading document, it was published knowingly and with intent to deceive. That is a

question of fact for you to infer from all the circumstances. It is a question of fact which requires the most careful consideration, and it is a question of fact as to which I need not remind you again the maxim peculiarly applies that a defendant is entitled to the benefit of the doubt. You have to consider all the facts.

I may remind you that there was, as we see from the balance sheet of 1911, a rather stereotyped or traditional form of balance sheet which was published by the Royal Mail, and when you get to these later years the same compendious form of balance sheet was continued, with some variations. Well, that is a matter to be borne in mind. It is also to be borne in mind that in the years 1926 and 1927 circumstances were changed.

As for the balance sheet itself, of course it is obvious to all of us that if it becomes known to the world that balance sheets of companies are not things which can be relied on, that is a very serious matter for the national affairs and commercial affairs of this country. But as I have already pointed out, these general considerations are not of value to you in determining the specific question, namely, whether there was a misleading balance sheet, and, if misleading, was it misleading to the knowledge and realisation of Lord Kysant; and if that knowledge and understanding was present to his mind did he then publish it with the fraudulent, wicked, and criminal intent which the law requires to constitute the offence? Matters of intent are matters which juries have to determine in every action of this character. The charge is a charge of fraud, fraudulent intent, and in a sense it can only be decided by a jury as a matter of inference from a consideration of all the relevant circumstances. So far as the other evidence is concerned, those are the relevant facts which have occurred to me, others may occur to you, for consideration. I do not know how far it is in any way definite or tangible at all in this connection, but you have the fact that if the dividend was 5 per cent. certain remuneration became due to Lord Kysant under his agreement, and was in fact collected by him in 1927. It was not collected in 1926, because it was not due, because the dividend was only 4 per cent., and in 1928 he did not collect it, though it was passed by the accountants. There is that circumstance, which is quite within your knowledge, and it is for you to determine what, if any, weight you should give to this matter.

In considering intent, it is always a question which juries consider in connection with possible motives. Without entering into any fine analysis, it is quite obvious that motive and intent are two different things. A man may have an intent for which no assignable motive can be given. On the other hand, a man may have assignable motives and yet he may not have the intent. One knows in these days of large commercial combinations the leaders of commerce who are in positions of importance may sometimes think of the affairs of the company rather in terms of the group, as it is called, than of the company itself. That, *prima facie*, is an evil, because after all, however many companies may be associated in a group, and however much they may be under the control of one man or a body of men, still the primary duty in law is as between the board or the directors and the shareholders of that particular concern, the people who have invested money in that concern. So that if you are looking at motives, the motives may be of a somewhat complex character. It may be the motive that the chairman of a concern may feel that he ought to keep the flag of his company flying until a certain stage is arrived at, when the flag must be lowered, or to change the metaphor, in the old sailing ship days the captain of a ship may carry on full sail because he is anxious to reach his destination, and may overstep the mark and lose either his sails or his masts, or both. The question of motive, therefore, in a case of this sort may be of a very complicated character, and you must, as well as you can, weigh all these considerations, because, as I say, intent is a matter of inference from all the facts and circumstances of the case.

You, of course, have heard the evidence which Lord Kysant gave, which I am not going to repeat in detail, because you heard it both in chief and in cross-examination; his evidence is in your recollection, and, as I understand, it may be summarised, perhaps imperfectly, in this way. His view, as I understand it, as stated by him in his evidence, was that there were a series of trade cycles, and that when you came to these critical years, 1926 and 1927, the cycle had been on the down grade, had changed in direction, and was tending towards the up grade; 1926, he said, started in the trough of a wave; 1927, he said, was better than 1926,

and therefore, even then, and under all the facts of the case, he felt he was justified in carrying on. He does not, as I follow it, deny that the time may have come—I am not sure that he is very explicit—for giving information to the shareholders beyond the mere fact of the dividend, but, as I gather, he says, he left the exact form of that information to the accountants, and was satisfied with what they did. These and other circumstances, which will be present to your minds, because you have heard the evidence, may be very material. No doubt, it was important to keep the status of the company and its reputation unimpaired so far as he could, because of this guarantee which we have heard about, which had to be extended in 1929, and which he hoped would be extended in 1929. I might, of course, read the whole of his evidence, but unless I read it all I do not think I could give a complete account, and you must rely for the details of that evidence, and any explanation, upon your recollection of what you heard him say. You have seen him in the witness-box, you have heard all his explanations, and you have had an opportunity of forming an opinion as to his personal attitude, as a matter of human understanding and human knowledge.

I do not really think on this matter, which is so essentially a matter for you, I can really help you any further. You will bear in mind that there are the two questions. If you think this balance sheet was published in such a form as to be misleading, then you have to ask yourselves, did Lord Kyslant know and realise that it was misleading? The fact that he ought to have realised it, of course, is only one element, if you think he ought to have realised it; and, secondly, if he realised that it was calculated to mislead, did he deliberately, wickedly, publish this with the intention of misleading and deceiving the shareholders in the concern in terms which cannot be disposed of by saying it is no use being wise after the event? Because, of course, if you have an experienced and very able business man with knowledge and realisation of facts, he is assumed to know, and he must know, all those circumstances which are only elicited in the course of this long and laborious and trying inquiry which has been necessary in this Court. Of course, you will remember this now that things have happened. It may be that, however experienced and able a business man he was, he may not have appreciated exactly all that was involved or might be involved in what he was doing.

Now I pass away from that, and that only leaves me one thing more, that is the charge in the counts in which Mr. Morland is concerned, and which, as you remember, have to be dealt with quite separately on the evidence which has been given applicable to him. You must keep your minds, as I am sure you have done throughout in considering Mr. Morland's case, definitely clear of any matters of which you have heard which are peculiar to Lord Kyslant, and which do not apply to Mr. Morland at all. The charge against Mr. Morland in the first and second counts is this: 'The said Harold John Morland did aid, abet, counsel, and procure the said Owen Cosby Philipps, Baron Kyslant, to commit the said offence.' That is repeated in the second count. So the charge against Mr. Morland is that of aiding and abetting. It is different from a charge of conspiring with him to commit an offence, because on a charge of conspiring the prosecution have to establish an actual agreement, a concert between the two men who are accused. In this case aiding and abetting presupposes that the offence has been committed, and alleges that the accused man, with knowledge that the offence was being committed, aided and abetted, that is to say, knowingly and deliberately helped the execution of the design for the committing of the offence. In the old days a man could not be charged with aiding and abetting an offence until the principal offender had been convicted, because you cannot aid and abet another man to do something which the other man does not do. Therefore, if Lord Kyslant did not commit the offences with which he is charged, the question of aiding and abetting cannot arise, because the question only arises when the jury are satisfied of the guilt of the man who is charged as the principal. Therefore, these matters, as far as Mr. Morland is concerned, only arise in that event; but, of course, if you are satisfied that Lord Kyslant was guilty of these matters charged against him in the first and second counts, then you would go on and consider whether Mr. Morland, with the same guilty intent, knowing what Lord Kyslant was doing, and knowing his guilt and wickedness, was aiding and abetting him in committing the crime.

A man may aid and abet to commit a crime, and yet do so quite innocently, not knowing that he was doing anything of the sort. He might do something

which was essential to the principal for the execution of the crime, and yet he might do that in the ordinary course, and without any consciousness that he was aiding in the offence. On the other hand, it is not necessary to prove on a charge of aiding and abetting that there was any deliberate communication or concert between the principal offender and the man who is charged with aiding, because if you have a deliberate purpose to assist, if you do something which you know will assist the principal in committing his offence, and you know that he is engaged in committing his offence, then your charge of aiding and abetting would be made out. Here, again, in the case of Mr. Morland you must be satisfied that the statement which he signed was false to his knowledge and was published by him—that is the result of signing it, because he signed the certificate with the intention of publishing it—with knowledge of its falsity and appreciation of its falsity and with the intention that it should deceive shareholders. Here, again, in the first and second counts of the case of Lord Kylsant and the case of Mr. Morland we are only concerned with the deceit practised against the shareholders and not against anyone else. There are many differences, of course, between Mr. Morland's position on any view, and that of Lord Kylsant. Mr. Morland, as the accountant and auditor of the company, had the accounts put before him, but not until they had passed the court of directors. He had nothing to do with the preparation of the accounts; he had nothing to do with the general policy of the company; he had no knowledge, except incidentally, perhaps, of the Meat Transport Co., of the subsidiary companies, or of their position. All he knew was about the dividends which from time to time he had to deal with in the accounts as representing the profits coming from those companies. He had, so far as can be seen, no motive at all for any deceitful intention, unless possibly it may be said he was too pliant with the wishes of those in authority, but unless that is to be treated as motive I do not see any motive at all. Of course, it may be said against him that he did in fact add the sanction of his name as auditor to a document which, taking those two years 1926 and 1927, was false and misleading.

As I pointed out in another connection, it is not here a question of whether or not he did something less than would be expected as the full duty of a careful and conscientious auditor. It is the business of the auditor to certify, after proper examination, if he can honestly and according to his skill and understanding, that the accounts of the company present a true and correct view of the state of the company's affairs, and to the extent that he is not satisfied that he can properly give that certificate his duty is either to qualify the certificate or to ask to have the accounts altered in such a way that he can sign them without qualification. In the case of Mr. Morland, it is obvious enough that in the year 1926, when the accounts of 1925 were being dealt with, he was not satisfied with the position, because he thought that some words ought to be added to intimate to the shareholders that the moneys which we know were being used were being used in order to produce the balance which appears. That being so, he thought, as indeed he has admitted, that without some qualification or another he ought not to give the certificate, and the qualification which he suggested, and which he put in, was those words, which you must all be tired of hearing, 'Adjustment of taxation reserves'—those words which Lord Plender has turned into plain English in the way in which I have already said. Mr. Morland says that that satisfied his doubts; he thought then that he had done enough to cure the defective character of the balance sheet or profit and loss account with those words. If he was right in that, if he had discharged his duty sufficiently and properly, then it seems, on any view, that the matter is, or ought to be, at an end. If, on the other hand, he was wrong in this sense that in a civil action, or in an action against him for not showing due care and skill, he would be held liable as a defendant because he had broken his duty and not fully discharged his office, then, again, his liability would be a civil liability in damages. That is assuming against him that he ought to have done something else before he signed the certificate; that he ought to have taken some drastic step and some more effective step in order to bring to the minds of the shareholders the true position of the company's affairs; and it may well be that he did not discharge his duty efficiently and properly. It may well be that an auditor placed in his position, as I venture to suggest, of a quasi-judicial character, stand-

ing between the directors and the shareholders, and protecting the interests of the shareholders against any possibility of their being misled by the directors—it may well be that he took an imperfect view, an inadequate view, of the very grave duties which rest upon auditors.

The profession of accountancy, as we know, is a very distinguished, very honourable, and a very essential profession in the commercial affairs of this country. Great trust must be reposed on the skill and judgment and honour of accountants. It may be that through error of judgment they fail to do all that the requirements of that high office demand. But, again, you are not concerned here with any question of civil liability or breach of duty. What you are concerned with, and what you have to determine, is whether there was, assuming that Lord Kyslant was guilty of this offence, a deliberate and conscious act on the part of Mr. Morland to help Lord Kyslant in carrying out that design by putting his hand to a certificate which he knew was not justified by the facts which he knew, and did not correspond with his duty; because, though the certificate stated in very clear terms that the accounts gave a true and correct view of the state of the company's affairs, he knew that they did not, and intended to give them currency and validity by means of his certificate with the knowledge that they did not give a true and correct view, and that he did so with a criminal and a wicked intent.

You have heard the evidence. He has called certain accountants whom you have heard. Three accountants have said in the witness-box that they would have signed the certificate in the same form—I suppose they would say under the same circumstances as Mr. Morland. That may be so or not, I do not know, but that is what they say, and I am sure that is what they believe at this moment. Of course, that does not relieve you of the duty of deciding as a preliminary step, whether it was a certificate that he ought to sign, or that he should sign in that form if he really appreciated his duty. As I have already pointed out, in such a way as almost to weary you, even if you come to that conclusion, you still have to decide on the question of the fraudulent and criminal intent, which is the third step you have to consider. If you think that he only committed an error of judgment, and something which fell short of his duty, you have still to consider, before you consider the question of intent at all, did he appreciate that he was doing wrong, or did he honestly believe that he had discharged his duty, however erroneous that belief was? Did he honestly believe he had discharged his duty by putting into the balance sheet in that and subsequent years those mystic words which are said to be so clear, but which may or may not be clear, 'Adjustment of taxation reserves'? Supposing he honestly thought that that was enough, then, on any view of the case, you could not find him guilty of fraudulent intent. However mistaken a man may have been, and however unfortunate the circumstances of his mistake may be, that does not constitute criminal intent or a criminal offence.

I have looked carefully through Mr. Morland's evidence. Probably you will remember the general substance of it, and I do not think that I can help you by going through it again. He does not dispute, nor, indeed, could he dispute, that he was dissatisfied with the accounts for 1925 in the form in which they were presented. He says: 'I thought it desirable. I do not think I can put it higher than that', because his view is that you ought not to go on taking those large sums of money to swell the balance and do it for so long without intimating that to the shareholders. He thought he had done enough. You may think he had not done enough; but if you think that he honestly believed he had done enough, then, apart from anything else, that ends the matter. I am not going back on what I said before; I shall simply leave the matter there with you, reminding you again, as I have reminded you on each previous matter, that in a criminal Court the jury have to be satisfied beyond reasonable doubt of the guilt of the person who is charged. That is a cardinal rule of British justice. In a Court of Law the jury cannot cast their eyes outside on other considerations. Their duty is to decide truly and indifferently, according to the evidence, with no other consideration than to decide justly according to their skill and understanding of the evidence before them; and, bearing that in mind, bearing in mind what I have said more than once, you will proceed to your duty. If you are satisfied beyond all reasonable doubt of the guilt of either of the defendants on any one or more of these counts, you will not be deterred by considering the consequences,

the very serious consequences, which must follow from your verdict. That will not deter you from your duty.

A jury, in a grave matter of this sort, have a very serious responsibility, which must be of the utmost importance in the affairs of the country, and in the commerce of the nation. But again, although that is so, though you must not shrink from doing what you think is right and proper, still you must be satisfied, in the sense I have indicated so often, before you come to any verdict against either of these defendants in this case. Now, will you consider your verdict?

[The jury returned a verdict of Not Guilty in favour of Lord Kylsant and Mr. Morland on both the counts relating to the publication of accounts of the company.]

TAYLOR AND OTHERS *v.* EUSTACE MILES FOODS (1921) LTD. AND OTHERS*

(Decided by EVE, J., in the Chancery Division, 29th January, 1932)

Auditing—Company accounts—Obligation to publish audited balance sheet—Right of auditor to attend general meeting

This was a motion by the plaintiffs in an action for an injunction to restrain the defendants from laying before the adjourned annual general meeting of the defendant company any profit and loss account or balance sheet for 1931 other than the profit and loss account and balance sheet audited by the plaintiffs, Messrs. Taylor and Perry, with their report attached thereto; and further, to restrain the defendants from excluding the plaintiffs from the adjourned annual general meeting of the company.

Mr. Swords, K.C., said the motion raised a very important question as to the rights of auditors. The conduct of auditors had been called into question in a number of cases recently, and the plaintiffs felt that it was their duty, having audited the accounts and made a report, to insist that the balance sheet with their report should be submitted to the general meeting of the company which had been called.

Messrs. Taylor and Perry were, it was claimed, at the material times auditors of the defendant company, and the third plaintiff, Mr. F. H. Gribble, was a shareholder in the company. The defendants were the company and all the directors. Messrs. Taylor and Perry became partners with Mr. Charles C. Smith on 10th June, 1931, in the business of chartered and incorporated accountants carried on under the name of Charles C. Smith & Co. There was no question that Charles C. Smith was the duly appointed auditor of the defendant company. Mr. Smith died on 12th June, two days after the partnership.

Messrs. Taylor and Perry carried on the business till 1st December in partnership. On 14th July, 1931, the defendant company directors passed a resolution appointing Charles C. Smith & Co. auditors of the company. They had been informed that Messrs. Taylor and Perry had been taken into partnership and were the sole partners. The company sent a copy of their balance sheet for 1931 to the auditors and the auditors in their report on it made certain statements.

They also said that in the circumstances they should attend the general meeting of the company and make a statement. On 17th December, 1931, the directors issued a notice convening a general meeting of the company for 29th December, 1931. They did not send out any copy of the balance sheet and auditors' report as required by the Act, but they sent out a notice that as a casual vacancy had arisen in the office of auditor it was impossible to circulate the report and accounts in time for the meeting. The meeting, however, had to be called to satisfy the Act and would be adjourned. Apparently the defendants treated the plaintiffs as no longer auditors because they had on 1st December sold their business to a Mr. Wright, who took it over on 2nd December. Defendants claimed that Messrs. Taylor and Perry were no longer the auditors and they had appointed another firm of accountants as auditors.

Mr. Justice Eve: Do you say a casual vacancy had not arisen?

Mr. Swords: Yes. These two gentlemen were still the auditors. But whether there was a casual vacancy or not when this meeting was held, the only balance

* [1932] *The Accountant* L.R. 19.

sheet and auditors' report in existence was the balance sheet sent to my clients in respect of which they had issued their report. We are not seeking to force ourselves on the company, but we consider it is our duty to see that our report is laid before the shareholders.

Mr. Cohen, K.C., who appeared with Mr. J. W. Lindon for the defendants, said that after the report was received from the auditors their authorised representative saw the directors and after that the directors came to the conclusion that certain matters did require reconsideration, and in the circumstances they could not circulate the balance sheet. It was also agreed that Mr. Taylor should have an opportunity of attending the meeting and making any statement he desired.

Mr. Justice Eve: Suppose the directors having received the report say 'we must investigate this', do you say they must go to the shareholders and say, 'we were going to put before you this balance sheet, but this has happened, and the auditors draw our attention to it. We have had a revaluation and we must recast our balance sheet'.

Mr. Swords: I do not say the balance sheet can't be altered but I say in this case it was not. We say that having been employed and having made a report on the balance sheet it was treated by the directors as a final balance sheet; there is an obligation on the directors to furnish the shareholders with a copy of the balance sheet and report and submit it to the meeting.

Mr. Justice Eve: Is a revised balance sheet ready now?

Mr. Swords: There is exhibited now a revised balance sheet audited by another firm of auditors.

Mr. Justice Eve: Has the adjourned meeting been called?

Mr. Cohen: No, it could not be called while these proceedings were pending.

Mr. Justice Eve: If Mr. Taylor attended the meeting he could say what he wanted and wash his hands of the whole affair.

Mr. Swords said the shareholders had a statutory right to have the balance sheet and report disclosed to them. He asked that the defendants should be restrained from laying before the adjourned meeting any balance sheet and report without also submitting the balance sheet and report in question.

EVE, J., said he need not trouble Mr. Cohen to reply, and he did not feel justified in making the amended order asked for. The auditors had thought it right to make criticisms of certain items in the balance sheet which was presented to them in the same way that they had been for the preceding eight years. The auditors took up rather a strong position and the directors were not prepared to accept their view. Time was running on, the general meeting had to be called, and the directors decided to get necessary information and if possible circulate a corrected balance sheet and such certificate relating to it as they could obtain in the time. When notice of the meeting was sent out it was not accompanied by any balance sheet, and to that extent the directors were in default, but if proceedings had been taken no doubt merely a nominal penalty would have been imposed, and there would have been an assurance by the directors that they were proposing to lay a revised balance sheet and auditors' report before their shareholders.

No Court could say that it was the directors' duty to put forward a balance sheet which it was now admitted could not be justified and that they should be prevented from putting forward a balance sheet showing the true financial position. The most any Court could do would be to say that the directors must explain the position to the shareholders and make a complete and full disclosure of all the circumstances. In the long run an honest disclosure was far more profitable than any partial disclosure. Upon the defendants undertaking that the old auditors should have the opportunity of attending and making a statement at the adjourned meeting, the Court did not see its way to make any order on the motion.

RE THE WESTMINSTER ROAD CONSTRUCTION &
ENGINEERING CO. LTD.*

(Decided by BENNETT, J., in the Chancery Division on 5th February, 1932)
Company—Liquidation—Alleged wrongful payment of dividend—Duties and liability of auditor

This was a misfeasance summons taken out by Mr. Sydney Edwin Smith,

* [1932] *The Accountant* L.R. 38. The case is sometimes referred to as *Smith v. Offer*.

F.S.A.A., liquidator of the Westminster Road Construction & Engineering Co. Ltd.

The respondents to the summonses were Mr. George Offer, Mr. Arthur Leslie Stevens, Mr. Harold Frank Hunt, and Mr. Beaumont Wakefield Shaw, who were directors of the company; Mr. Sidney Milson Macquire, manager and secretary to the company, and Mr. Sidney Cronk, chartered accountant, carrying on business as Sidney Cronk & Co., auditor to the company.

Mr. Spens, K.C., for the liquidator, stated that the claim was for repayments by all the respondents of £1,246 17s. 8d., part of a dividend declared in respect of the period ended 31st March, 1928, his case being that there were no profits out of which the dividend could properly be paid; also as against all the respondents for repayments of £345 16s. 10d. paid to Mr. Stevens as a commission on profits under his agreement with the company for the same period, as against all the respondents except Mr. Cronk for repayment of a further sum of £200 paid to Mr. Stevens for the period commencing 1st April, 1928, and finally as against Mr. Hunt, Mr. Shaw and Mr. Stevens a declaration that £621 4s. 6d., the balance of the dividend declared and purported to be left with the company as a loan at interest, was not due and payable. The liquidator's complaint was over the valuation in the balance sheet of work in progress (the inclusion of sums for work not done until after the date of the balance sheet), that no allowance was made for reinstatement charges payable by the company to sub-contractors, and that no provision was made for bad debts.

Bennett, J.: The company worked solely for the Post Office and local authorities, and was not likely to have bad debts.

Mr. Spens said there was an item in July, 1927, which the Post Office disputed and did not pay and no inquiry whatever was made by the auditor about it.

Bennett, J.: With regard to the overvaluation of work in progress, what do you say the duty of Mr. Cronk was? We must have his standard of duty and see if he fell below it.

Mr. Spens: There is a duty imposed by law upon Mr. Cronk to check the figures.

Bennett, J.: The figures are prepared and certified by an officer of the company. What is the duty of the auditor? What more has he to do?

Mr. Spens: He must take steps to check the figures in the certificate of the work in progress.

Bennett, J.: What steps?

Mr. Spens: He cannot accept the certificate. He must ask how the figures are arrived at. It is his duty to check the accuracy of each figure.

Bennett, J.: Neither the books nor the invoices would enable the auditor to ascertain the value of the work done when the balance sheet was being prepared. Is it the practice in engineering companies, when auditing balance sheets, to call for the daily sheets which would show the work done daily?

Mr. Spens: I say it was part of his duty to call for the documents which showed how much of the job was done before and done after the date of the balance sheet. That is the figure that had to be checked and I submit that it was the duty of the accountant to check it. He is not allowed to rely on the certificate of the manager of the company.

With regard to reinstatement liabilities, Mr. Spens said that it was the duty of the auditor to see that they were fairly represented in the balance sheet, and that if he had checked the actual figures in the books instead of confining himself to the figures, he must have known that there was money due from the company, and allowed some figure in respect of them.

Bennett, J.: You say that in this respect there is no general standard of duty but a particular standard arising from what was seen by him in the invoices he checked. You are seeking to throw an extraordinarily heavy and onerous duty upon the auditors—to go outside the documents to see if the figures are correct.

Mr. Spens said his case was that instead of there being a profit in the year ended 31st March, 1928, there had been a loss. When the company went into liquidation there was a deficit to creditors of about £7,000.

Mr. Smith, of Messrs. Hoale, Smith & Field, the liquidator, said he was an incorporated accountant. He doubted the accuracy of the company's accounts because of the high profit of over £3,000 in relation to the paid-up capital of £800, and he directed an investigation into them. The actual paid-up cash capital

of the company on 8th March was £820 2s. This was subsequently increased to £3,800 4s. He had no difficulty in checking the reinstatement liabilities. The figure of £1,543 13s. 7d., which appeared in the balance sheet, was incorrect, as a large number of accounts in respect of work done by local authorities for the company prior to the end of March had been omitted. The total amount omitted was £1,403 19s. 11d. He got on to the track of these invoices from the entries in the company's books, and when he was unable to find an invoice on the files, he wrote to the public authorities to certify the amounts.

Mr. Spens: Why do you say that these omitted items should have appeared in the accounts?—Because they were actual liabilities at the 31st March, 1928, and owing to their omission the liabilities of the company were understated and the trading profits were overstated.

Mr. Spens: Were the books of this company in a satisfactory state?—In a very unsatisfactory state.

Have you found a number of insertions in the books by the auditors? Did the books show all the liabilities provided for in the balance sheet?—Not until the auditors made the books agree with the balance sheet. Excluding the reinstatement liabilities referred to, the auditors included liabilities amounting to £600 left out by the company's officers.

If, as an auditor, you found an omission of liabilities from the company's books, would that make you suspicious of the books generally?—It would.

Would that put you on special inquiry as an auditor?—It would put me on inquiry, and there were other factors. From the materials which passed through the auditors' hands and were initialled by them, they must have been aware that there would probably be outstanding liabilities in respect of reinstatement work on 31st March which would not be invoiced to the company until after that date. In a number of cases they made provision for other liabilities.

Bennett, J.: Do you say that the auditors should have examined all the invoices that came in down to the time that they certified the balance sheet?—It is not the general practice among auditors but in the circumstances of this particular case it should have been done. If the invoices had been examined the auditors could not have failed to discover the existence of the liabilities which were not included in the balance sheet.

Bennett, J.: What were the circumstances which you say made it incumbent upon Mr. Cronk to examine the invoices down to the time that the balance sheet was certified?—The incomplete state of the company's books, the nature of the invoices which had actually passed through his firm's hands and the general circumstances. In the majority of trades it is customary to render the invoice for work done a month later, and this should be taken into account.

With regard to the value of work in progress, Mr. Smith said that in some cases credit was taken in the profit and loss account for the original invoice price of G.P.O. contracts, although the price had been reduced by the G.P.O. and that in other cases the company took credit for work which was not done until after the 31st March.

Counsel for the various respondents said that they challenged these allegations and insisted upon their being proved by persons who were in a position to know the facts.

Bennett, J., said that would have to be done.

Mr. Smith said that the documents with which he checked the figures came from the company's files. He also complained that no provision was made in the accounts for any possible bad debts, although there was an item of £141 18s. outstanding from July, 1927, which the G.P.O. had repudiated.

Cross-examined by Mr. Gover, K.C., on behalf of Mr. Cronk, Mr. Smith said that when he was appointed liquidator in November, 1929, he caused the whole of the accounts to be investigated, giving special instructions with regard to work in progress and reinstatement charges. At the conclusion of the investigations, he formed the opinion that the auditor, Mr. Cronk, had been guilty of breaches of professional duty in respect of all the matters charged against him in the summons. As an expert accountant and auditor, that was the opinion he honestly held when the summons was issued and still held. He agreed that Mr. Cronk was not at first made a party to the summons but said there was always an intention to make him a respondent.

Mr. H. S. King, F.C.A., of the firm of Sir Maurice Jenks, Percival & Co., chartered accountants, giving evidence for the liquidator, said he had twenty-five years' experience of audits. So far as he knew he had seen all the books, correspondence and documents in the liquidator's possession. He knew that part of the liquidator's claim in this case was that certain work in progress had been overvalued. He had never known a case in which the auditor did not check the work in progress.

Mr. Spens: What steps would he take?—In most cases there is a costing system which would enable the auditor to check the figures before him.

Have you examined the costing system of this company?—I have examined the costing book which one cannot describe as a 'system'. As a 'system' it was absolutely valueless—non-existent.

If the system is valueless, what other steps should the auditor take?—It must necessarily depend on the circumstances. The main point is whether he had anything that puts him on inquiry. If there is no costing system and no means of verifying the figures, he is entitled to rely on the figures given him by the company's officers, but I can hardly imagine any occasion, except in the case of a company abroad, where the figures cannot be verified. There was in this case material by which the auditor could have checked the figures.

What material?—Mainly the diary sheets and copy invoices rendered to the G.P.O. which were in the company's possession when the balance sheet was certified.

Had they been used to check the figures, do you consider that the figures which appeared in the balance sheet would have been inserted?—I do not think so.

After your investigation of the books and documents in the possession of the company, did you come to the conclusion that the figures for work in progress in the balance sheet were excessive?—Yes, I did.

Do you think there were matters in this particular case to put the auditor on inquiry as to the accuracy of the figures?—I do.

Witness added that he had tried to put himself in the position the auditor was in at the time. The first thing that would have put him on inquiry was a letter written by the company to Messrs. Cronk & Co. in May, 1928, and then there was the profit and loss account showing a high profit on the comparatively small amount of capital (including the loan) employed during the period.

Bennett, J. (to Mr. Spens): You will have to prove the value of the work actually done at the date of the balance sheet, and that it was below the sums for which credit has been taken.

Mr. King said he had also inquired into the position with regard to the reinstatement charges and that in his opinion the figure appearing in the profit and loss account as the company's liability under this head was inaccurate. The liability was understated with the result that the profits were overstated. He was of opinion that the auditor certifying the balance sheet should have discovered this.

Questioned with regard to the debt disputed by the G.P.O. witness said that having regard to the form of the account in the ledger the auditor had thrown upon him the duty of examining every item in it.

Bennett, J.: What was there peculiar in the form of the account?—It is a running account relating to a large number of contracts, and each contract should be considered on a separate footing. Having ascertained that the G.P.O. liability had remained outstanding for ten months, the auditor ought certainly to have made inquiry about it.

Mr. Spens: If an auditor is going to certify that a certain sum of money is due to the company, is there a duty upon him to satisfy himself that it is a good debt?—Yes.

Bennett, J.: I do not think this is a matter for the witness.

Mr. Spens: Was there any provision in these accounts for bad debts at all?—No.

Was that a factor which should make the auditor more careful to check the debts?—I am not sure that would be so in this case.

Mr. Lionel Cohen: Meaning that you would not expect bad debts when you are dealing with the G.P.O.

Mr. Gover: Do you say there is a general principle of auditing that when there is a running account which relates to or includes a number of separate contracts it is a duty incumbent on the auditor to examine every single item in the account?—No, it is not general.

Mr. Gover: Then I cannot understand your criticism.

Asked in further cross-examination how it was possible for an auditor to know that he must deduct for some liability to a sub-contractor if he had no knowledge of the sub-contract at all, witness replied that if the auditor had no knowledge of it he should inquire.

Mr. Gover: Why should he suppose that a construction company in one or two rare cases employed a sub-contractor?—I can quite conceive that I might put the question in certain cases.

Mr. Gover: It is easy to be wise after the event. With regard to work in progress, if the auditor is given a statement of values by the proper and presumably competent official of the company, and has seen such entries in the books and documents as he honestly and reasonably thinks verify the statement, is there anything further he can do?—Only to accept the certificate if there is nothing to put you on inquiry.

Supposing you were put on inquiry and you had reasonable ground for believing that there was no other document, would you hesitate to accept the information?—All he can then do is to accept the certificate.

Evidence was then called as to the dates when the Westminster Co. started and finished various G.P.O. contracts with a view to establishing the liquidator's allegation that credit was taken in the balance sheet for the value of work in progress which was not completed until after 31st March, 1928.

In order to avoid the time and expense involving in the calling of numerous supervisors from the G.P.O. and representatives of public authorities the parties agreed to accept the documents as evidence of the work in progress, and the liquidator was recalled and cross-examined in great detail as to the estimates he had made of the work done before and after 31st March, 1928.

Mr. Lionel Cohen, K.C., opening the defence for Mr. Offer and Mr. Hunt, said that the charges of misfeasance against them were that they had been parties to the declaration of the dividend and the payments to Mr. Stevens. With regard to the second payment to Mr. Stevens (£200), his case was that it was done to get rid of him and was a very good bargain. Mr. Stevens was entitled to a salary of £400 a year and a commission of 10 per cent. on the net profits before anything was carried to reserve, and his agreement had three years to run. The position was that on the balance sheet he was entitled to £345 and in those circumstances it was desired to get rid of him and he was induced to put an end to the agreement on the payment to him of £200. With respect to the payment of the dividend, that was done on the faith of the balance sheet certified as accurate by the company's auditors, who were experienced chartered accountants in whom the directors had every confidence. If the profits were high as compared with the capital employed, so also was the turnover.

Bennett, J.: Prima facie the responsibility for the balance sheet is on the directors. The documents are theirs and in the first instance they must take the responsibility.

Mr. Cohen: Their responsibility, I submit, is no higher than this—they must employ proper people to keep the books and prepare the balance sheet. They are entitled to rely upon the auditors to see that the effect of the books is properly set out in the balance sheet.

Bennett, J.: It must depend upon the facts in each case. Is not the test whether the directors in handling other people's money acted reasonably?

Mr. Cohen cited cases in which it had been held that the duty of a director was to act honestly and to exercise the same degree of skill and care as an ordinary man might be expected to take on his own behalf.

Bennett, J.: That cannot be the true test. A great many people do not care twopence about their own affairs. They have a great many more interesting things to do and employ other people to look after their affairs.

Mr. Cohen: The judges were speaking of business affairs.

Bennett, J.: Do you challenge the allegation that there were no profits?

Mr. Cohen said he would like to reserve his decision on the figures until he had heard the evidence of Mr. Macquire. His clients relied on the certificate of Mr. Macquire and the certificate of the auditors.

Counsel added that he thought Mr. Smith had given his evidence very fairly.

Bennett, J.: It is the duty of directors to know something about the business of the company.

Mr. Harold Frank Hunt, giving evidence, said that until he became chairman of the Westminster Road Construction & Engineering Co. his only experience of company matters had been that he was at one time a director of a company that built houses in Australia and of a gramophone company. He became associated with the Westminster Co. through Mr. Macquire, in whose integrity and ability in this type of work he had every confidence.

At the time the balance sheet was being prepared he believed that all liabilities had been allowed for and that the company had made a profit of £3,000. He asked Mr. Macquire how the figures for the work in progress were made out and how they could be verified and he replied that they were checked by the diaries kept by the G.P.O. supervisors and the company's men on the job, and that by this means the actual work done could be checked down to the last day. So far as he knew the accounts were being prepared by Messrs. Sidney Cronk & Co. He personally took no part in the preparation of the accounts. He had no reason whatever to suppose that the dividend was not being paid out of profits or he would never have consented to it. He was so confident of the success of the company that in October, 1928, he took up additional shares, and in November, 1928, guaranteed a bank overdraft for £2,000.

Cross-examined by Mr. T. F. Davis, for Mr. Macquire, witness agreed that he never asked to see Mr. Macquire's certificate. He was satisfied that the auditors would go into everything and see that all was right. He first heard that reinstatement charges had not been inserted in the balance sheet when he returned from America in March of this year.

A few days before a board meeting in June, 1928, he said to Mr. Buckle, of the accountants' firm, who was engaged on the profit and loss account, that the company had apparently achieved a very fine year and asked him if he was satisfied that a profit of £3,000 had been made. Mr. Buckle said that he was quite satisfied but that he had to rely on Mr. Macquire's figures as he could not go out and measure the work done himself. It was never discussed or suggested to him that there were any sub-contracts connected with the balance sheet at all. He did not know they existed. He agreed that it would not be right to bring into the balance sheet the amount the company was to receive for work it was doing without making allowance for payments that had to be made to sub-contractors. The matter of reinstatements he left entirely to the chartered accountants. At no time did he see the books, accounts or vouchers. Apart from his conversation with Mr. Buckle he never had any discussion with anybody from the auditors' office with regard to the accounts. He had never seen Mr. Cronk until three days ago.

Mr. George Offer, another of the respondent directors, said he was an accountant, not qualified by examination, in the employ of Messrs. Sidney Cronk & Co., and had forty years' experience with the firm. He became connected with the Westminster Co. through Mr. Hunt and partly opened the books of the company and generally supervised them until he was appointed a director. He took shares in the company and was so satisfied with its progress that he recommended the shares to his friends. He took no hand in the preparation of the accounts for the balance sheet of March, 1928, as being a director he thought it was advisable to stand aside so that there should be no question or suggestion of interference.

Mr. Offer said that as a precaution which a director ought to take he asked Mr. Macquire if he was practically certain that all the liabilities were in, pointing out to him that the profit shown was large and if any liabilities were not included, the company would have to pay income-tax on that profit a year before it was made. Mr. Macquire replied that so far as he knew everything was in. Witness said he was satisfied that the profit as shown in the balance sheet was correct because the accounts were prepared by Mr. Buckle, who was a fully qualified chartered accountant, and had investigated them very closely. With regard to the G.P.O. debt, it was not considered a bad debt in 1928. It was for work done outside the ordinary contract work, and it was hoped that the G.P.O., who were giving it consideration, would pay the bill.

Cross-examined by Mr. Davis: Had he been auditing the balance sheet he would have sent for the reinstatement invoices relating to work done up to 31st March.

If invoices had been handed to you which had been only received by the end

of March, I suggest that on looking at them it would have been obvious to you that they related to an earlier period and that there were more to come for March?—Yes.

Since you knew that there was work in progress on the 31st March it followed that reinstatements must have been accruing for the whole of March?—Yes.

Bennett, J.: Assuming that in June, 1928, you were preparing the company's profit and loss account for the year ended 31st March, 1928, would it have been obvious to you that the profit and loss account did not or might not include all the reinstatement liabilities up to the end of March.

Mr. Offer: Yes, I am afraid I would have to assume they were not all included.

Bennett, J.: A very frank answer.

Mr. Davis: The invoices rendered before the 31st March provided the auditor with ample material to enable him to see that there was a period uncovered by them?—Yes, I think so from what I have seen since. I do not think that they were ample but there were materials.

Cross-examined by Mr. Gover: His answers to Mr. Davis were qualified to this extent: the view he would take of the accounts would depend upon what he saw in the books, the information he obtained from responsible officials of the company, and the invoices or accounts which were available.

Mr. Offer added that everything was congenial in 1928 and that it was all suspicion now.

Questioned by Mr. Spens, K.C., he said he did not consider the profits surprisingly large. He agreed that the result of the year's working depended upon the accuracy of the figure of £6,500 for the value of work in progress actually done. He did not think it necessary, as a director, to take steps to check the figure himself, as he relied upon Mr. Macquire and understood that the details had been worked out and checked in the company's offices. He assumed that all the work had been done by the end of March. He also agreed that if it was a fact, as alleged the liquidator, that accrued liabilities to sub-contractors had been omitted, the balance sheet was 'utterly hopeless'.

In re-examination, Mr. Offer said that when he stated that if he were auditing in June, 1928, the profit and loss account for the year ended 31st March, 1928, it would have been apparent to him that there were liabilities for reinstatements which had not been included, he meant it would have been obvious to him in the light of his present knowledge.

Bennett, J.: You have given your evidence in the very difficult circumstances of this case with great fairness and candour.

Mr. Offer: Thank you, my lord.

Mr. Sidney Milson Macquire, manager and secretary to the company, said he was the practical outside man and had no accountancy experience. He relied upon Mr. Offer to look after the accountancy side of the office, that being the reason for Mr. Offer's introduction in the business.

Mr. Macquire said he had a discussion with Mr. Buckle as to how the work in progress should be valued, and pointed out to him that the invoice prices included all the cost of reinstatements. He sent Mr. Buckle particulars of all the work he had had to estimate and was satisfied that Mr. Buckle had gone into them and then naturally thought his figures were right. In everything he did he had acted in perfect good faith.

With regard to the G.P.O. bad debt, his lordship said that at the most this could only be an error of judgment, and not misfeasance, and Mr. Spens said he would not press the point against any of the respondents.

Mr. Gover, K.C. (to witness): I put it to you that you never met Mr. Buckle under any circumstances until after the end of March, 1928?—I do not agree.

Mr. Gover: I suggest that your statement is an entire fabrication.

Mr. Macquire: I beg to differ. If it was not Mr. Buckle it was a representative of Messrs. Cronk & Co.

In further cross-examination Mr. Macquire said he considered it the duty of the auditors to refer to the copy invoices and diary sheets to ascertain the exact value of the work done down to the end of March. He never told anybody that he had done the actual measurements himself. It was impossible for him to do so as there were so many hundreds of Post Office jobs going on and, besides, he was not

responsible for that part of the work. He also denied that he ever told Mr. Buckle that there was no documentary evidence by which his (witness's) figures of the work in progress could be verified and that he would have to take his word for their accuracy.

Did you tell him that you had taken the utmost care in working out the figure and that you had taken everything into consideration including reinstatement accounts?—Most certainly not.

In reply to Mr. Spens, K.C., witness said that in the schedule of work in progress which he sent to Mr. Buckle he deliberately intended his figures to be full invoice values. That was the arrangement with Mr. Buckle.

Irrespective of liabilities to sub-contractors?—Absolutely so.

Between the date when you sent Mr. Buckle the particulars and the date when you signed the certificate you had no discussion with him with regard to reinstatements or sub-contracts?—No.

When you signed the certificate did you not realise that the total was approximately that of the figures you supplied to Mr. Buckle?—No.

You swear that?—I do.

Mr. Arthur Charles Buckle, of Messrs. Sidney Cronk & Co., said he was an associate of the Institute of Chartered Accountants. He passed his final Examination in November, 1927. He had been engaged in auditing books of companies where work in progress was involved but not of the same type as was under consideration here. On 10th April, 1928, he was instructed to audit the Westminster Co.'s books and that was the first time he had been in the company's offices. He had never come into contact with Mr. Macquire prior to that date. He found the invoice book badly written up and had to make adjustments. That made him extra cautious. Mr. Offer took no part whatever in the audits.

Mr. Buckle, continuing his evidence, said that he found the costing records of the company quite useless, and the first step he took to verify the work in progress was to look at the sales day book which formed only a partial check, as the whole valuation was based on measurements.

Mr. Vaneck: Did you discover anything that appeared to be incorrect in the schedules furnished to you by Mr. Macquire? Yes, there was an item included which ought to have been deleted because the account had been rendered before the 31st March and, therefore, could not be work in progress.

Witness said he did not come across any documents in the company's possession which would enable him to check the value of the work in progress at the end of March, and he asked Mr. Stevens if there were any such documents. He was referred to Mr. Macquire, who was responsible for the valuation. Mr. Macquire told him that the measurements had been taken at the 31st March and that the valuation was based on them. He then inquired whether he could have the working figures in order to check the ultimate results that appeared in the schedules. He understood from Mr. Macquire that these details were measurements of all classes of the company's work, and that in order to follow them he would need the technical knowledge and, bearing in mind the complications in pricing G.P.O. work, he came to the conclusion that Mr. Macquire was right, and that the details would be unintelligible to him. So far as the G.P.O. contracts were concerned, Mr. Macquire said that the work done had been agreed with the G.P.O. representatives, and that there was no reason for doubting the accuracy of the figures.

Did you know of any other documents or source of information which would enable you to verify the valuation of the work in progress?—No. Mr. Macquire told me there were no documents apart from his measurements.

Had you any reason to doubt the accuracy of Mr. Macquire's statements to you?—None whatever.

Witness added that during his conversation with Mr. Macquire no reference at all was made to sub-contracts, and so far as he was aware the company performed its own work. He asked Mr. Stevens for all the accounts relating to reinstatements, and gathered that he was given all the accounts that were likely to come in relating to the relevant period. Mr. Stevens said he was not aware of any other liabilities. In his conduct of the audit he never had any reason to doubt the integrity of Mr. Stevens or Mr. Macquire.

Mr. Davis (for Mr. Macquire): With the knowledge you had at the time you satisfied yourself that you had done everything you possibly could do?—Yes.

Looking back with the knowledge you have got now, would you have been satisfied?—No.

In further cross-examination, Mr. Buckle, in reply to Mr. Davis, said he appreciated that reinstatements were necessary and that he understood Mr. Macquire had allowed for any liability in arriving at his work-in-progress valuation. They were lump-sum estimates, and he understood that they were reduced to allow for any possible liability.

Did you ever ask him for a list of the liabilities you thought he had deducted?—No.

Why not?—So far as I can recollect our conversation was merely a discussion of principle and not of detail. I had been unable to verify the work in progress myself, and it would not have helped materially to have verified this.

When did you discover that reinstatements had been omitted from the balance sheet?—I do not think any discovery was made before this action was commenced.

Did you do any work on the September, 1928, accounts?—I did.

Were the entries in the reinstatement account as they now appear?—Yes, up to September.

Did you look at these reinstatement invoices?—I did not personally deal with the reinstatement accounts at all.

Did you notice that there were entries relating to March? It was staring you in the face.—I did not examine the account. The whole thing had been checked by whoever was assisting me and I was not going through it a second time.

If anyone checked these accounts he must have seen these entries dated March?—Yes, he must have done.

If it had been done with any care it should have been brought to your notice that there were entries relating to another period—it seriously affected your previous work?

Bennet, J.: You wanted to find out if there had been a profit between March and September?—Yes.

If you brought into account work done for the company in March it would not add to the profits?—No, they would be deflated.

Mr. Davis: When you found that there was a huge loss as opposed to a profit in March, did you not look round to see how the difference came about?—The difference was explained to me, I believe, as being contributed to by various factors which I can give you if you like.

Did it not occur to you that something might have gone wrong in your previous account?—No.

In reply to Mr. Spens, K.C., witness agreed that apart from his checking by the sales day book and the assurances of Mr. Macquire he took no steps to check the road or G.P.O. contracts. He had to rely upon Mr. Macquire's assurance about the measurements, and that they related to work actually done at the end of March and did not include work done subsequently.

Mr. Spens: I am going to suggest to my lord that that is not a sufficient discharge of your duties as auditor.

Questioned as to adjustments made in the G.P.O. invoices which Mr. Spens said were generally in favour of the G.P.O. and against the company, Mr. Buckle stated that he thought he gave consideration to the question and came to the conclusion that as there were adjustments in favour of each side there was no necessity to make provision or a reserve in respect of the alterations.

Mr. Spens: I suggest that it escaped you altogether and you did not consider it at all?—I am afraid I do not know definitely. I was quite aware it was going on and think I must have considered it.

Mr. Sidney Cronk, F.C.A., said he carried on business at 9 Fenchurch Street, E.C., and had been in practice for nearly fifty years. He entrusted the matter of this particular audit to Mr. Buckle, who was a fully-qualified chartered accountant, and left it entirely to him. He had no doubt whatever as to the competency and experience of Mr. Buckle to do the job properly, and he had no doubt whatever now that he had done it properly. Mr. Buckle passed his Final examination with high honours and obtained the winning prize. He was a young man of exceeding promise.

In reply to Mr. Spens, K.C., he said he asked Mr. Buckle the ordinary question

as to whether every care had been taken to ascertain the assets and liabilities of the company before he (Mr. Cronk) signed the balance sheet.

Mr. Gover, K.C.: Did you realise that you were solely responsible for the audit?—I have always accepted the responsibility.

This concluded the evidence.

Mr. Lionel Cohen, K.C., summing up the case for Mr. Offer and Mr. Hunt, submitted that the principle of the general application with regard to the duties of directors was laid down by Mr. (now Lord) Justice Romer in the *City Equitable* case, where he stated that a director in the exercise of his duties need not exhibit a greater degree of skill than could be reasonably expected from a person of his knowledge and experience. He agreed that the directors were responsible for the employment of a competent staff, but contended that, having fulfilled that obligation and installed a proper system of book-keeping, &c., and having the accounts audited by qualified accountants, they could not be held to be liable in respect of any negligence on the part of those employed.

With regard to the valuation of work in progress it was not part of the duty of the directors to adopt the attitude of hostile examiner towards Mr. Macquire in whom they had every confidence.

Bennet, J.: Not necessarily to cross-examine him, but £6,583 was a fairly substantial sum. They have all said that they realised its importance, and I can quite imagine a good many questions they could have put with regard to it. It seems to me to lead to the conclusion that they did not realise their responsibilities or that they cannot be under any obligation in the matter. I do not know.

Mr. Cohen: If the law goes to the extent your lordship indicates it would cast such a burden upon directors that they would not act.

Bennett, J.: I am not so sure. What did the board know on 27th June and what did they consider?

Mr. Cohen said that the work done depended upon measurements and the board being unable to check them themselves, they were entitled to rely upon the assurance of the only person who could say whether the figure was right or not. They did all they possibly could. The company was started at the suggestion of Mr. Macquire, and the whole business revolved around him. Mr. Offer was entirely to rely upon Mr. Macquire's certificate and Mr. Buckle's satisfaction with that certificate.

Bennett, J.: Mr. Buckle was a very young man to conduct the audit. Does it not make you shudder when you think of what you did during your first few years at the bar?

Mr. Cohen: I should have shuddered still more if I had been an accountant, but we must remember that Mr. Buckle had previously spent four years in another office and that he passed his Final examination with high honours.

Mr. Cohen continued his argument as to the limitations on the responsibility imposed by law on directors.

Bennett, J.: All this trouble has arisen through your omission to ask questions about the figures in the balance sheet which you ought to have asked. Had you asked them you would have discovered what the liquidator discovered.

Mr. Cohen: Your lordship is assuming in all these directors the possession of a trained mind.

Bennett, J.: If they are not bound to ask questions I agree that there may be no case against them.

Mr. Cohen: It is clearly not their duty to do the acts which enabled the liquidator to find out what was wrong.

Bennett, J.: It is a very curious case. Everybody seems perfectly honest—there is no doubt whatever about that—but instead of there being a profit of over £3,000 there is a substantial loss and it is said this can happen although the auditors do their work and the directors do their work. I do not believe it. It is inconceivable to me although I am not prepared yet to say who is responsible.

Mr. Cohen submitted that the directors were entitled to rely upon the auditors and Mr. Macquire.

Bennett, J.: They are the people you blame?—Yes.

Mr. Stevens, addressing the Court, pleaded that he had no reason to doubt the assurances given with respect to the accuracy of the figures, and that he accepted them in perfect good faith.

Mr. Davis submitted on behalf of Mr. Macquire that the payments complained of did not flow from anything he did and that he was entitled to rely upon the auditors and Mr. Offer. Mr. Buckle, said counsel, was put on a task which was beyond him in his then state of knowledge and was guilty of obvious acts of negligence which he would never commit again. The persons responsible for the distribution of this money on the basis of a profit were the auditors, primarily, and, secondly, Mr. Offer, to whom Mr. Macquire looked in all accountancy matters.

Bennett, J.: If Mr. Macquire carelessly gives a certificate which includes a hopelessly wrong valuation upon which people act in good faith, is he not to suffer for his carelessness?

Mr. Davis: Not if there was machinery set up in the office to check the figures as was the case here. The negligence that caused the payments was that of the auditors and of Mr. Offer who was an accountant. Mr. Macquire furnished the information and it was for them to check the accounts. Mr. Macquire knew nothing of accountancy and could not check their figures. The board would never have declared the dividend on the figures of Macquire without the assurance of the auditors and Mr. Offer that they were accurate.

Bennett, J.: He took no steps to see that the figures he certified were accurate?

Mr. Davis: The details he gave had been in the hands of the auditors for a fortnight. Was he to go to another firm of accountants to check the auditors?

Bennett, J.: No.

Mr. Davis went on to assert that 'the carelessness of the auditors had been so gross that it could not possibly have been contemplated by a man in the position of Mr. Macquire'.

Bennett, J., pointed out that in his figures of work in progress Mr. Macquire made no allowance for liabilities.

Mr. Davis replied that this was surely the accountancy side of the business.

His lordship observed that it was Mr. Macquire's delinquencies they were now considering.

Mr. Davis urged that all Mr. Macquire did was merely to put forward a summary at sale prices and leave the auditors to deal with the accounts. The auditors never asked for a list of liabilities and did not discover the omission of reinstatement liabilities from the balance sheet until after these proceedings started.

Bennett, J.: That will not help you if you did not perform your duties.

Mr. Davis proceeded to contend that even if Mr. Macquire had been negligent it was not the cause of this loss.

Mr. Gover, K.C., summing up the case for Messrs. Sidney Cronk & Co., said that so far as they were concerned he did not think it necessary to apologise for the extraordinary time the case had taken as it was not simply a matter of money liability either of Mr. Cronk or Mr. Buckle but in both cases, and in particular that of Mr. Buckle, it was a question of professional reputation. He would have to look at the authorities to show what view the Courts had taken of the responsibilities and liabilities of auditors. They had the right of access to the books, accounts and vouchers of the company and were entitled to require from the directors and officials of the company such information and explanations as might be necessary for the performance of their duties and having obtained these, they had to state that the balance sheet exhibited a true and accurate account to the best of their knowledge and belief of the financial position of the company. It was no part of their duty to give advice to the directors or shareholders as to what they ought to do and they were not assurers of the accuracy of the books. They were not bound to do more than exercise reasonable care and skill and were not bound to be suspicious where there were no circumstances to arouse suspicion. It was not part of their duty to take stock and in this case Mr. Buckle not only had the certificate of Mr. Macquire but also his assurance that there were no materials by which his figures could be verified except by a man with technical knowledge of G.P.O. contracts. It was not the duty of Mr. Buckle to assume that Mr. Macquire was recklessly careless, while on the other hand he was entitled to rely on the accuracy of Mr. Macquire as an expert.

Mr. Gover cited various authorities and submitted that the following proposals as to the duty of an auditor in a case like this were fairly deductible:

(1) It was his statutory duty in 1928—it is slightly different now—to satisfy

himself that his report on the balance sheet was properly drawn up so as to show a true and accurate view of the company's affairs according to the best of his information and as shown in the books of the company.

- (2) He was not bound to exercise more than reasonable care and skill even in a case of suspicion, and what was reasonable care and skill depended on the circumstances of each particular case.
- (3) He was expected to be a watch-dog but not a bloodhound and still less a clairvoyant.
- (4) His primary duty was to be performed by an examination of the books of the company and he was not responsible for liabilities or other matters not in the books and not reasonably brought to his notice in any other way.
- (5) He was entitled to rely on information or explanations obtained from the appropriate and responsible officials of the company unless there was reason to doubt their accuracy.
- (6) On any information or explanation of value obtained from such appropriate and responsible official he was not bound to take any further step to verify the matter even although known means of doing so existed, and
- (7) It was no part of his duty to go through the minutes, letter books, or files of documents of the company for the purpose of seeing whether there might be evidence of liabilities or other material matters not disclosed in the books or any information or explanation given.

Mr. Gover proceeded to read the evidence and on the facts submitted that Mr. Buckle, who was only 21 at the time (the first occasion on which his age was given), but a very able young man, had done everything in the matter of investigation which it was possible for him to do in the conduct of this audit. The books at that time were in a hopeless state of confusion, the costing system being admittedly useless, and Mr. Buckle had to rely upon the figures of Mr. Macquire and his assurances, more important still, his certificate, that they were accurate. There was no obligation upon Mr. Buckle to make a roving or fishing expedition on the files to see if there was anything wrong.

Bennet, J., suggested that Mr. Buckle had failed to detect things that a man of greater experience would have discovered.

Mr. Gover: He failed to be a bloodhound?

Bennet, J.: Oh no, an old watch-dog would have discovered them.

Mr. Gover: In a chaotic office?

Bennett, J., said he thought that Mr. Cronk was wrong in leaving the audit to such a young man.

Mr. Spens, K.C., in his final speech for the liquidator, said that his case divided itself into two portions. In the first place he had to satisfy the Court that the dividend had been paid out of capital and then he had to satisfy the Court that the respondents had respectively been guilty of such breaches of duty as led to the payment, and consequently were responsible to make good to the assets the money improperly paid away. The respondents had strenuously resisted the case on both grounds, but, in his submission, the liquidator had proved up to the hilt that the dividend was paid out of capital. With regard to the directors his contention was that if they failed to exercise their judgment as commercial or mercantile men they were liable, and in this case none of the directors exercised any judgment whatever in passing the accounts.

Bennett, J.: Can they not rely upon an experienced accountant and honest auditors? What else have they got to do?

Mr. Spens: They must go through the accounts and consider whether the results were likely and probable in view of what they knew. They cannot merely accept the accounts without exercising any sort of judgment. They were put upon inquiry when they saw such a large profit on so small a capital. Between them they had all the knowledge required and had one single intelligent question been asked, the whole accounts would have collapsed.

As to the auditors, Mr. Spens said that in the same way the amount of the profit should have put Mr. Buckle on inquiry at once and it was in the light of that he asked the Court to judge on the insufficiency and ineffectiveness of the investigations.

JUDGMENT

BENNETT, J., in giving judgment, said that the liquidator had proved to his

satisfaction that the company did not earn a profit of £3,458 during the period in question. No charge of dishonesty was made against any of the respondents and having seen all of them in the box and heard their evidence he was satisfied that with respect to all the charges made against them in these proceedings all the respondents acted honestly and in good faith. It was the common practice, he was told, in the case of small companies for the auditor of the company not merely to act as auditor and to certify the accuracy of the balance sheet but also to prepare it, and that was what was done in this case. Mr. Cronk, personally, took no part either in preparing the balance sheet or in auditing it, but he was of course responsible as the company's auditor for what was done by his servant in connection with the balance sheet. The task of preparing the balance sheet and profit and loss account and of auditing the former was entrusted to Mr. Buckle, who was then 21. He had entered Mr. Cronk's employ in October, 1927, had passed his Final examination for admission to the Institute of Chartered Accountants in November, 1927, and had been admitted as an associate member of the Institute in March, 1928. It was upon the shoulders of this young man, without any supervision and with but very little assistance, that the whole burden of preparing the company's balance sheet and profit and loss account and auditing the balance sheet fell. The accounts in question were considered by the directors at a board meeting on 27th June, 1928, and passed. The liquidator had satisfied him that instead of there having been a profit of £3,458 there had been a profit only of £297, and that the balance sheet did not therefore disclose a true and accurate statement of the company's position. Was this erroneous certificate due to failure on the part of the auditor to perform his statutory duty? The answer in his lordship's judgment was in the affirmative and Mr. Cronk was responsible for the failure of his servant, Mr. Buckle. It was settled law that an auditor did not discharge his duty if he merely saw that the balance sheet accurately represented what was shown by the books on the material date. His duty with regard to the ascertainment of unrecorded liabilities must depend upon the facts of each particular case and must be determined by the nature of the business carried on and the practice of the persons or bodies with whom the company did business of sending in their invoices. If the auditor found that a company in the course of its business was incurring liabilities of a particular kind, and that the creditors sent in their invoices after an interval, and that liabilities of the kind in question must have been incurred during the accountancy period under audit, and that when he was making his audit a sufficient time had not elapsed for the invoices relating to such liabilities to have been received and recorded in the company's books, it became his duty to make specific inquiries as to the existence of such liabilities and also, before he signed a certificate as to the accuracy of the balance sheet, to go through the invoice files of the company in order to see that no invoices relating to liabilities had been omitted.

The evidence had established to his satisfaction that no experienced auditor would have failed to ascertain the existence of the liabilities omitted from this balance sheet. It was the auditor's duty to make specific inquiries as regarded liabilities for reinstatement work incurred before 31st March. Mr. Buckle made none and he never examined the invoice files after 30th April. His lordship said he saw no ground for thinking that if Mr. Buckle had inquired for outstanding reinstatement liabilities he would not have received accurate information respecting them. The real fact was, he believed, that Mr. Buckle through lack of experience failed to appreciate the bearing the reinstatement liabilities had upon profits and thought it was not necessary to have regard to any such liabilities not entered in the books before 31st March. With regard to the overvaluation of work in progress the expert evidence was that it was the duty of the auditor to check the figures at which work in progress was brought into the balance sheet. It was the duty of Mr. Buckle to satisfy himself that nothing was included in the work valued as in progress on 31st March which was in fact done after that date. He had also to satisfy himself that all expenses or liabilities incurred by the company in connection with the work so valued had been brought into account. The check made by Mr. Buckle was useless. His lordship said he was satisfied on the evidence that there

was ample material in the possession of the company on 18th June, 1928, with which Mr. Buckle could have tested the accuracy of the figures given him. Therefore he came to the conclusion that the auditor was guilty of negligence in checking the value of work in progress on 31st March, 1928, and was responsible for certifying as accurate the balance sheet in question.

With regard to the directors, his lordship said that they all believed that the balance sheet truly represented the position of the company. He regarded all of them as honest men and could not hold them responsible for paying dividends on the faith of the balance sheet certified as accurate by Mr. Sidney Cronk, who was a fellow of the Institute of Chartered Accountants. Mr. Macquire would be responsible if it had been his duty to make the statement as to the work in progress. The directors had not imposed any such duty upon him and the law did not impose any duty upon him.

The liquidator was entitled to recover against Mr. Cronk the money of the company wrongly paid away with interest and costs and the summons would be dismissed as against all the other respondents with costs.

The question of costs was discussed on 8th February.

After hearing the arguments of counsel, Mr. Justice Bennett said it was now the settled practice that the liquidator in such cases must pay the costs of the respondents who had successfully resisted the proceedings taken against them and recoup himself if he could out of the assets of the company, and he must make an order accordingly. This might have the effect of deterring liquidators from taking proceedings against persons whom they considered responsible in part for the misfeasance but he could not help it.

It was stated that the assets of the company would show a deficiency.

ARMITAGE v. BREWER AND KNOTT*

(Decided by TALBOT, J., in the King's Bench Division on 15th December, 1932)

Auditors' liability for negligence

In the King's Bench Division on 12th, 13th, 14th and 15th December, Mr. Justice Talbot heard an action brought by Mr. Joseph Armitage, architectural designer and sculptor, of 12 Page Street, Westminster, against Messrs. Brewer & Knott, chartered accountants, of 31 Budge Row, Cannon Street, London, claiming damages for alleged negligence in auditing the plaintiff's books by reason of which over £1,400 defalcations were not detected. Negligence was denied. Mr. Stuart Bevan, K.C., and Mr. Valentine Holmes (instructed by Messrs. Slaughter & May) appeared for the plaintiff, and Mr. Thomas Eastham, K.C., and Mr. W. Bowstead (instructed by Mr. William Charles Crocker) represented the defendants.

Mr. Bevan said that a lady, a Miss Harwood, employed by the plaintiff was prosecuted and in December of last year pleaded guilty and was sentenced to fifteen months' imprisonment. The defendants were making quarterly audits of the plaintiff's accounts, which this lady kept, and the plaintiff said they did not take the necessary steps to prevent his suffering from her irregularities. The plaintiff was well known for his decorative stone work and was in a good way of business.

Mr. Brewer's brother was an old friend of Mr. Armitage, and the members of the accountants' firm were at that time Mr. Brewer and Mr. Mills. Mr. Armitage's accounts were for several years in the hands of this firm. In April, 1929, this lady became Mr. Armitage's secretary, book-keeper and cashier, and he learnt then to his surprise that the work the defendants had been doing had been simply to balance the books and get out accounts for income-tax purposes; they had not been doing auditing, as distinct from balancing. No blame attached to anyone, and Mr. Mills and Mr. Brewer said their fee would be 50 guineas for a periodic audit, with a master audit at the end of the year, and Mr. Armitage said he would pay that, as he must be protected against irregularities or loss.

The loss which Mr. Armitage eventually traced was about £1,400. The petty cash defalcations were £63. The chief trouble was in the time sheets. The plaintiff's case was that there was a point when the loss in the latter should have been

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detected and after that point he suggested the auditors should be treated as accountable for the loss. In some cases, it seemed, receipts were absent. When Mr. Armitage adverted to a customer's complaint of an error in an account—a complaint by one of his biggest customers—the auditors pointed out that they did not investigate accounts before they were sent out to customers. Mr. Armitage informed the auditors that this lady had told him of a balance of hundreds of pounds which he found did not exist and had made a mistake about his banking account.

On one occasion Mr. Mills replied that certain errors would not be discovered during audit because the checking of accounts sent out did not come within the scope of that particular audit. The defendants contended it was not negligent to fail to ascertain a series of matters set out in the pleadings. The accountants, Mr. Armitage suggested, passed unreceipted invoices as vouching for payments, and did not check time sheet totals into the wages book; passed duplicate entries in respect of single payments; and failed to ascertain that workmen were not working for times with which they had been credited or that initials of foremen were not genuine. Weekly advances to an employee, Mr. Cole, for expenses, appeared in the petty cash and also his account of the eventual items which made up those totals.

Mr. Eastham observed that in some of the cases to which Mr. Bevan referred, it was impossible for the auditors to have compared the documents so as to satisfy Mr. Bevan, because they belonged to different quarterly audits.

Mr. Bevan added that the plaintiff's loss was not disputed nor that it was sustained in the way alleged, but the auditors strongly denied negligence. The question for the Court, as he conceived it, was whether, and when, the accountants should become responsible. All the further losses were due to failure to discover loss at a particular date, and he said it should have been discovered then, given proper supervision.

Mr. Justice Talbot made the comment that he saw there were receipts unstamped. He should have thought that those would have attracted the attention, and provoked the comment of an auditor.

Mr. Eastham said again that vouchers for them were in different accounting periods.

Mr. Bevan said the same hand which kept the wages book paid out the wages, and it was not pointed out how unfortunate it was that everything was left in the same hands. Improperly cast time sheets should have shown what was going on, apart from the question whether the auditors ought not to have altered the system of dealing with the wages. Workmen and foremen should have been interrogated as to time sheet signatures.

Mr. Armitage, giving evidence, said he told the auditors that he was at the mercy of his employees, and if it came to an alternative between attending to his artistic work and letting a secretary defraud him he should have to accept the latter alternative. His books were in a mess and he asked his auditors in the beginning to clear up the accounts and put the lady cashier on the right lines. The auditors in the period that followed gave him no indication that anything was going wrong; on the contrary, half a dozen times when he asked, they gave satisfactory personal reports. They considered the lady an excellent book-keeper and told him he would be unwise to part with her. They told him he should get quite a good book-keeper for £3 10s., and he was paying more than that. Mr. Mills said nothing surely could go wrong; their check would reveal it. When witness found something wrong with the account of a principal customer, it was proposed that someone should assist the lady. An amount given to the insurers for workmen's insurance was provided as £20,000, when it should have been £14,000. A Mrs. Boyd was called in to assist. Witness later told the lady cashier she must go, and she then told him that he had been going behind her back to Mr. Mills about her; he did not know that she had heard of his conversations with Mr. Mills. Witness had become nervous about the state of his books before anything was discovered. Eventually he parted company with Mr. Mills and called in Messrs. Price Waterhouse & Co.

Cross-examined, Mr. Armitage agreed that the loss caused by forgeries in time sheets was £1,258; he got rid of the lady cashier in question in October, 1931.

Answering Mr. Eastham, Mr. Armitage agreed that receipts, as well as time

sheets, had been forged and altered in parts. He had a rule in his office that time sheets might be destroyed six months after audit, which might account for the disappearance of certain documents.

Mr. George Henry Clark, member of the Society of Incorporated Accountants, on the staff of Messrs. Price Waterhouse & Co., said he inquired into the series of frauds and found them of two types, petty cash errors and falsifications in connection with time sheets. An invoice of goods for a railway company was marked C.O.D., carriage forward, and being in the plaintiff's possession was treated as a receipt, though the line for receipt was not signed.

Answering the judge, Mr. Clark said it was undesirable that one person should have uncontrolled management of the books in any concern.

Mr. Justice Talbot: In the case of the mistakes of the heads of departments there is no one to put them right except the auditors.

When Mr. Bevan inquired what was the date at which the witness thought he himself would have detected what was going on, Mr. Clark replied, 'In April, 1930'. In November, 1929, 16s. 6d. in an invoice was passed as 6s. 6d.

Mr. Justice Talbot: And there are two more cases which to anybody not an accountant would look queer. It must have been assumed that people would act on the principle of Mr. Mantalini, who always looked at the totals.

Mr. Clark said there was a case where the '3' in a bill for 3s. 6d. seemed to have been rubbed and the account appeared for £1 1s. 6d. The '3' could clearly be seen beneath. Mr. Clark said he thought he should have asked for an explanation. Another discrepancy was—goods 16s. 9d.: paid 6s. 9d.

Mr. Clark said certain items Mr. Bevan put to him, he should have passed 'in a blue sky'. Cole's advances for expenses might not have revealed the duplicates in the petty cash, and might not have been challenging, but he should have expected to find attached to Cole's vouchers the supplier's receipts. Four or five further items Mr. Bevan pointed to, Mr. Clark thought anyone might have passed, although he considered there should have been a question when £1 17s. 6d. petty cash in the alleged voucher appeared as 17s. 6d. An accountant who had seen the irregularities in the petty cash would have felt it his duty to look into the time sheets, and on the face of them many of the time sheets called for investigation. Money items and hours were both wrongly added. He should have referred, he thought, to the foreman for elucidation and then the cat would have been out of the bag.

Mr. Bevan remarked that alternative time sheets might have been made out.

Mr. Justice Talbot: And totals taken from one and items from the other. In one case on the same day totals work out to different results. Some of the errors are against the lady.

Mr. Bevan at this stage informed the judge that certain figures were wrong, he regretted to find, in copies prepared for his lordship and himself; this introduced an added discrepancy which was confusing for counsel and the Court.

In cross-examination, Mr. Clark agreed with Mr. Eastham that the defendants could not have had the suspicions he himself had in making his investigations. He himself would have passed small items on the explanations given. He would also have made suggestions on the way the wages were kept.

Mr. Eastham: We are not charged with negligence in regard to the amendment of the system, and before April, 1929, there were many items in petty cash for which there were no vouchers. There was then no question of fraud. Mr. Clark replied that he should have felt he had done his duty when he had drawn the attention of his client to it.

Mr. Justice Talbot: If the principal says, 'I am not going to bother about that', there is an end of it.

Mr. Eastham: And that is my case with regard to many of these matters. If Mr. Clark had told his principal, 'Here is a 6s. 8d. item for petrol not vouched—'

Mr. Clark: I quite agree I should have thought no more about it.

Mr. Eastham: And that is what has happened here. Receipts have been lost. Many auditors do not trouble about any cash payment under a pound. Is it not the general practice to take that line?

Mr. Clark: It would depend entirely on the instruction I had received in the first instance.

Mr. Clark said the examination of petty cash vouchers was junior clerk's work.

In a case where it was said £1 had been added to the actual amount he would probably not have detected it himself.

Mr. Justice Talbot observed that he realised that some of the discrepancies in the schedule of instances would not be noticed by the auditor because they were in different audits and came under the notice of different junior clerks.

Mr. Eastham: If Miss Brewer, in auditing, drew the attention of the principal to the absence of a receipt for £3 12s. 4d., as she did, would you say there was negligence in that instance?

Mr. Clark: No, certainly not. One may be told vouchers are missing.

Mr. Eastham: And, if further, Mr. Armitage had said he did not wish to be troubled by small matters?

Mr. Clark: One would not pursue it.

Mr. Justice Talbot: One has to remember that these auditors had been put in a special position by being told that Mr. Armitage had neither time nor inclination to go into his private affairs and wished them to do it for him. It is not a question of particular items, but of whether their accumulation should not have put the auditors on inquiry.

Mr. Clark conceded that the manner of the book-keeping progressively improved, and that he would not suspect fraud from a few errors only. But an alteration of 6s. 1d. to 16s. 1d. he should regard as noticeable.

Mr. Justice Talbot: One would notice it when the two figures are on the same document cheek by jowl.

Mr. Eastham: One may make mistakes in checking.

Mr. Justice Talbot: Of course there may be mistakes, if nobody made mistakes there would be no negligence.

Mr. Eastham said he suggested that some addition of single figures might have been made while the audit was going on and after the document had been passed, say in the lunch interval between checking and addition: at one time the method was to test the time sheets by examination of samples. There was a change in the method of auditing them at a later period.

Mr. Justice Talbot interposed that he had to see what Mr. Armitage was entitled to expect. He had raised at one stage the question of the sufficiency of the checking.

Mr. Eastham said that with regard to Cole's advances for expenses, he was instructed that when Mr. Armitage was consulted he replied, 'Oh, I trust Cole; he has been with me for years.'

Mr. Clark: In that case I should not bother further.

Mr. Eastham said a number of documents forged had been removed and destroyed.

Mr. Clark: Documents, of course, were destroyed with consent.

Mr. Eastham: Supposing another receipt was produced and checked?

Mr. Clark: You could not blame a junior clerk in that event.

When Mr. Eastham said there was no ground for suspicion in certain cases, **Mr. Justice Talbot declared it was the duty of auditors to be suspicious, that was what they were there for.** If everybody was honest and careful there would be no need for auditors.

Mr. Eastham observed that their duty was to find out mistakes.

Mr. Justice Talbot: But what looks like a mere mistake may often set you on the track of something worse.

Mr. Eastham: Will Mr. Clark tell us—in common practice, is it not the custom of the junior clerk to read the invoices?

Mr. Clark: Yes, I will say that it is not the custom to read them. I think that is quite fair.

Mr. Justice Talbot: That cuts at the foundation. If you say the petty cash vouchers are never read, that may deal with the whole of these cases. Internal evidence in one invoice would suggest the total was 1s. and that the '1' had been altered to '6'.

Mr. Eastham asked Mr. Clark whether, if he saw 13s. 6d. in the petty cash and an invoice for £1 3s. 6d., with the figures close, he would not pass them as equal?

Mr. Clark, amid laughter, exclaimed: No, indeed, would you?

Mr. Justice Talbot advised Mr. Eastham to stick to the law and answer 'No'. His lordship added, 'it is so near a legal figure that I expect you would have passed it'.

Mr. Eastham asked: In the review of time sheets, as a rule an auditor's duty is discharged if he makes a test and does not check the whole of the calculations?

Mr. Clark assented. 'If you do not get definite instructions', he said, 'you make a test.'

Mr. Eastham: And the further security is here that the time sheets seem to have gone, customarily, through three hands in the firm. With 700 or 800 time sheets per quarter, you could not deal with every item for a fee of 50 guineas a year, including the getting out of balance sheets?

Mr. Justice Talbot: There is a sentence in the correspondence which will have to be considered sometime—'we check calculations and additions of all time sheets'.

Mr. Eastham replied that a time arrived when a change of method occurred in the audit. There would be a question of the date of the new arrangement, as between 1930 and 1931.

Mr. Justice Talbot: That sentence, I suppose, does undertake a particular duty as to the wages sheets.

Mr. Eastham put it to witness that the auditors' alterations of time sheets showed that they had made inquiries.

Mr. Clark agreed. The lady auditor, he said, had clearly taken trouble and had had to make alterations. The forgeries he had seen were very cleverly done.

As to rubbing out, it was not unusual for workmen to alter their time sheets.

Mr. Clark explained that the result of his own inquiries had been to show that many hours had been added to time sheets, but with the agreement of figures there might be little to excite suspicion.

Mr. Eastham put it that sometimes one tested by the horizontal line of totals and sometimes by the vertical column.

Mr. Clark replied that if one were testing, one should look at all the details. In a sheet before him, while the horizontal totals added correctly, four hours on Monday was shown as eight hours at the foot.

Mr. Justice Talbot: In a sheet with not many figures, there are three mistakes in arithmetic. Is it customary to find as many mistakes in time sheets as in some of these? I do not know whether they are a fair sample. I should have thought that, to alter artfully, one would leave as little to get hold of as one possibly could. But these errors are obvious and elementary.

Mr. Eastham: Your lordship will notice that the mistakes in arithmetic are in the last audit.

Mr. Clark: Time sheets may have been altered to agree with cheques drawn, and whoever made the alterations must have trusted to luck.

Mr. Justice Talbot: These are such clear and palpable mistakes that they look more like incompetence than knavery.

In reply to Mr. Bevan, in re-examination, Mr. Clark said he thought these irregularities should have been discovered, and inquiries made, by the end of the third audit, which was completed on 28th February, 1930.

Mr. Justice Talbot: At the third audit the auditor should, already, have been suspicious? Yes.

Mr. Bevan: Early in 1931, Mr. Mills told Mr. Armitage there was no need for him to be worried, adding, 'Nothing serious could go wrong, because my check would inevitably reveal it.' Would the method of checking employed by Mr. Mills inevitably have checked anything that went wrong?

Mr. Clark thought he should have found the alterations and mistakes in the time sheets. 'I myself', said Mr. Clark, in his last word, 'should not have passed all these documents in different departments when made out by one hand.'

This concluded plaintiff's case.

Mr. Eastham, opening the case for the defendants, declared that the first wrong time sheet found among 700, at the fourth audit, could not have aroused suspicion of dishonesty.

Mr. Justice Talbot: What will be formulated against you is that you did not exercise professional care in doing the duty you were employed to do.

Mr. Eastham: The checks are not made in order to see whether it is right that payments should be made, but to see whether payments are vouched for.

Mr. Justice Talbot: I am not so sure. There are two separate duties: (1) to check the calculations and additions of all wages sheets, and (2) to check totals of wages sheets into wages book.

Mr. Eastham: Mr. Armitage did not swear that he instructed us to check every time sheet.

Mr. Justice Talbot: I think he entrusted your clients with great powers, to act on his behalf, on the express ground that he had neither time nor inclination to do the work himself. He put great trust in the auditors. He wanted them to make an audit such as nothing serious could get past. And that is what the defendants said they could give him and had given him.

Mr. Eastham: I do not think we can be liable to that extent.

Mr. Justice Talbot: There are limits, of course, such as reasonable skill and care.

Mr. Justice Talbot said nobody could look at one particular altered receipt, with care, without suspecting fraud.

Mr. Eastham rejoined that, if all the other scheduled items in that audit were explained, a single document like this could not brand an audit as negligent.

'I contend that nothing can be said against my clients', said Mr. Eastham, 'on any view, until 25th June, 1930. The question is not whether we have made mistakes, but whether we have made negligent mistakes. In audit No. 6, for instance, when all has been explained, there remains but one doubtful document in the petty cash transactions with a couple in a mass of 600 or 700 time sheets.'

Mr. Charles William Argent, chartered accountant, for many years senior audit clerk to the defendants, gave evidence of conducting the second quarterly audit alone. C.O.D. on a bill for £1 13s. 6d., he said, justified him in passing it, because the goods could not have been delivered without payment.

Mr. Justice Talbot: If that is not the invariable practice, the assumption falls to the ground?

Mr. Argent assented. The receipt for the amount appeared in the following audit.

Mr. Wilfred Mills, chartered accountant, of nineteen years' standing, stated that to 1929 the firm did accountancy work for income-tax for Mr. Armitage, but did not purport to audit. He dissented from Mr. Armitage's statement that they were asked in April to audit, and put the instruction in August. When Mr. Armitage, in an interview, used the word 'audit', witness explained the difference between accountancy work and audit. Miss Brewer said it would be impossible to do a full audit for the year ending 30th June because of missing vouchers. They said they would do what they could, especially in relation to the wages sheets and vouching the purchases, for which there would be invoices.

Mr. Bevan pointed out that Mr. Armitage twice used the word 'audit' in documents before August, once in March, and the defendants' account spoke of 'audit of accounts'.

Mr. Mills said their use of the word there was unfortunate. He had to explain to clients sometimes the difference between accounting and audit. He was absolutely sure the arrangement for audit was in August.

Mr. Bevan observed that in June Miss Harwood marked two pages as reserved 'in case they are required for the purpose of audit'.

Mr. Mills replied that neither Mr. Armitage nor Miss Harwood at that time understood the meaning of the word 'audit'. The defendants' audit note-book showed the programme of work from 29th July. He did not remember Mr. Armitage saying he must have protection, after his experience with three cashiers. The accountants had put his books right. What Mr. Armitage said was simply that he wanted an audit. He did not use the word 'fraud'. From time to time, when asked, witness told him Miss Harwood was a satisfactory book-keeper, his view being based on what he learned from Miss Brewer, who was responsible for the majority of the audits.

Mr. Bevan asked, with reference to omission to make up the stock book, if it would facilitate fraud, supposing the stock book were not kept posted.

Mr. Mills said he thought so. It was better, but not essential, that it should be fully entered. Witness instructed Miss Brewer to see that it was written up. After an employee of Mr. Armitage left, in 1930, there was a change of method, the wages sheets being checked in full instead of tested by samples, as previously. They told Mr. Armitage that if he thought there should be the full checking they would include it in the audit.

Mr. Bevan: Why was it not necessary to do it from the outset?

Mr. Mills replied that they had had a double check on the work of the employee

who had now left. She was an assistant secretary who had something to do with the wages sheets.

Mr. Justice Talbot: There is no document or interview in which this change was authorised?

Mr. Mills answered that he could only say that there was a change. He denied that he said, 'nothing serious could go wrong because our check would inevitably reveal it'. When he saw Mr. Armitage, he should have said things were all right.

Mrs. Betty Wotton Beech, formerly Miss Brewer, chartered accountant, qualified in November, 1929, admitted associate early in 1930, since 1930 a partner in the defendants' firm and in the office since 1923, said that before 1929 the accounting for Mr. Armitage did not include audit. Some audit work was done in September, 1929, for the period down to the end of June, 1929.

There had been a muddle in the accounts and vouchers missing before Miss Harwood arrived. After that there was improvement. The interview at which witness was present, when an audit was asked for, was in August, 1929. Every time she went she had spoken to Mr. Armitage of the number of small mistakes, and many were put right as they went along. Mrs. Beech explained that she accepted a document for the railway as a receipt because of initials in the corner. In a case where 5s. 1d. appeared as 15s. 1d., it would be natural to accept the 15s. 1d. in the position in which it was found. For another item she ticked, she knew she had seen a receipt; the receipt had since disappeared; for other cases ticked in the petty cash there must have been receipts. A document put in, she should not have accepted as a receipt for a guinea without some other document. In one case the explanation would be that the foreman paid the dealer direct and omitted to obtain a receipt and therefore had signed the invoice himself.

Mr. Justice Talbot observed that that was not recollection but probability and did not help as a check on Miss Harwood.

Mrs. Beech: There was no one, my lord, to ask, but Miss Harwood.

Mr. Justice Talbot: That made your task the more difficult, no doubt.

Mrs. Beech said a change in the manner of dealing with the time sheets occurred when Miss Harwood intimated that she had not time to check the calculations in the wages sheets, which had previously been done by Miss Harwood and an assistant secretary, and witness gave instruction to her clerk to check the wages sheets in detail. This made no difference in her firm's charges. An entry in her diary showed that she saw Mr. Armitage on the keeping of the stock book in September, 1931.

In cross-examination, Mrs. Beech said she knew Miss Harwood only in the office. Her book-keeping appeared more satisfactory than her predecessor's.

Mr. Bevan said the whole wages system would be in the hands of Miss Harwood, keeping the wages book and drawing the money. Did Mrs. Beech realise that Miss Harwood would be uncontrolled in drawing wages for workmen who did not exist, when something would be handed to the foreman? Did she realise that Mr. Armitage was imperilled if Miss Harwood chose to be dishonest in the wages account? Mrs. Beech: I do not know that we thought about it, in the beginning.

Mr. Justice Talbot: And when the disclosure came, it was a matter of absolute astonishment to you?

The witness answered 'yes'. When Mr. Armitage said Miss Harwood appeared to know of his inquiries about her, he suggested leakage in the accountants' office. Witness at once told Mr. Mills there was no leakage as far as she was concerned.

Mr. Bevan: I suggest you, like Miss Harwood, did what you could to help her, and your relationship was quite confidential?

Mrs. Beech: Not in the least.

Mrs. Beech said Miss Harwood herself told her of Mr. Armitage's question about certain errors.

Mrs. Beech explained, as to the time sheets, that she raised questions and she understood that the foreman was being inquired of. She certainly trusted Miss Harwood in the sense that she did not think she was deceiving anybody. As to the duplicated entries of Cole's drawings for expenses, witness mentioned to Mr. Armitage the need for having his vouchers, and Mr. Armitage said he had told Cole to bring in receipts 'where he could'.

Mr. Bowstead, for the defence, submitted that with petty cash losses of only £69, it did not follow naturally that there would be losses of many hundreds in the time sheets, and there were no time sheets till the fourth audit. The wages sheet losses were therefore too 'remote a consequence', in law, for any negligence in respect of the petty cash to be recoverable.

Mr. Justice Talbot said one of the objects of an auditor was to enable the employer to get rid of a fraudulent servant, and the natural result if one left a fraudulent book-keeper was that frauds would follow.

Mr. Bowstead contended it might be assumed that the person delivering goods C.O.D. collected the cash.

Mr. Justice Talbot: Supposing the defendants are liable—and I think there is nothing in your point about the remoteness of damage—when do you say the damages should begin? The plaintiff says at the end of the third audit.

Mr. Bowstead said, at the end of the sixth audit.

Mr. Bevan pointed out that Mr. Mills took no part in the audit and was able to exercise an unprejudiced judgment and he was not asked whether he thought the method of audit justified. Mr. Bevan asked for £200 for Messrs. Price Waterhouse & Co.'s investigations, and total damages of £1,259. He added that he desired to say that the large customer who had been referred to in Messrs. Price Waterhouse's certificate had in no way suffered by what had happened.

JUDGMENT

Mr. Justice TALBOT, giving judgment, said Mr. Armitage's business was peculiar in that he must be absorbed in his artistic work and, but for his reputation as architectural designer and sculptor, which depended upon that, he would have no business to audit. He had to conduct his studies and a large business, and he must have a way of escape from the distraction and annoyance of uneasiness as to whether his accounts were properly kept. His lordship thought any new arrangement in regard to the audit having been made about August, 1931, was contrary to the weight of the evidence, and particularly Mrs. Beech's. The documents at the beginning set out that the defendants would vouch all payments with receipts in petty cash, check calculations and additions of all wage sheets, check totals of wage sheets into wages book and check weekly totals, with other detailed provisions, and accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was a small matter; they undertook a rigorous check, and they did so because that was what their client wanted. He told them he wanted protection against petty frauds. The defendants knew uncontrolled powers were committed to the person in the office Miss Harwood filled. They did not refuse the audit because of a risk of employing one woman in that kind of position. What was required of them in the circumstances entailed more laborious work and more vigilance. They undertook that work, and the reassurances that Mr. Armitage frequently asked for they gave. That was a sufficient account of the duty they undertook. Had it been performed with the care they owed the plaintiff and which could be expected under their retainer from competent and upright professional people? His lordship thought the answer to that was that it had not. However much it might be wrapped up, the defendants' case came to this, that systematic fraud for two and a half years by one person could not be detected by the exercise of reasonable care on the part of the accountants. His lordship did not like to use strong language, but that appeared to him to be bordering closely on nonsense. On the evidence, it was an allegation which did not bear a moment's examination. If it needed an answer, it was that it had been detected with such accuracy that Miss Harwood had pleaded guilty at the Central Criminal Court. It was doubtless true that to detect required minute examination of a large number of documents, but that was exactly what the defendants undertook to do. Mr. Mills' letter of 25th September, 1929, on the work they had just done, showed what the defendants understood to be their duty. As to the suggestion that some things were too trivial to notice, audits differed greatly as to scope and special instructions. A 6s. 1d. had been altered to 16s. 1d. That was passed in what purported to be a meticulous examination. The most casual inspection would detect the discrepancy on the voucher; both figures were there. His lordship was struck by the audacity with which many of these frauds were committed. It looked as though Miss Harwood

had found that she had nothing very formidable to fear in the way of audit. It was the duty of the auditor to bring that 10s.—which was indicative not only of fraud but of forgery—at once to the notice of the principal. That one piece of paper raised a grave suspicion. It was of critical importance. It was by little things like that that forgeries and frauds were found out. To examine only a sample of the time sheets his lordship thought contrary to the terms of the statement he had indicated. But the point was that to the vouchers they did examine, the defendants did not bring proper care. It was no use looking at such documents as were found here unless one did it with scrupulous accuracy. If in turning over documents, all of one was not seen, then the document must be taken out of the pile. The suggestion that something was the kind of thing a junior clerk would have passed was an unjust imputation on junior clerks. But if junior clerks could not do the work, they must be got rid of; auditors could not get rid of their responsibility by delegating it to junior clerks. There were many items which Mr. Clark said frankly he might have passed, but when there was something to make one uneasy his lordship thought the defendants should have been doubly vigilant. Against systematic dishonesty the plaintiff had no protection except the defendants, and it was for the protection against Miss Harwood principally that he paid, and that he was entitled to get. Mrs. Beech, who gave her evidence very fairly, entirely realised that. She did not make any difficulty about admitting it. 'We realised it was part of our duty to check her transactions and to protect the plaintiff against irregularities or dishonesty of hers.' His lordship was afraid it could not be said that that was very steadily pursued. As to a number of matters, Mrs. Beech was content to accept the assurance of Miss Harwood. In the matter of the duplication in the petty cash of Cole's disbursements, there was no suggestion against Cole of dishonesty, but a very moderate amount of inquiry and care should have detected these double entries when they began. That a multitude of time sheets were fraudulent was admitted. His lordship was satisfied that if the defendants had done their duty before the time sheets came into the case, Miss Harwood would have gone and there would have been an end of her frauds. It was clear that a good many documents were suspicious on their face and called for inquiry. The defendants seemed to have been content to treat the time sheets as simply a matter in respect of workman or foreman—to guard against fraud there—but the time sheets turned out to be the largest part of the money frauds Miss Harwood committed.

His lordship entered judgment for the plaintiff for £1,259.

*Re ALLEN, CRAIG & CO. (LONDON) LTD. AND Re THE COMPANIES ACT, 1929**

(Decided by BENNETT, J., in the Chancery Division, on 15th March, 1934)

Company—Balance sheet—Director's liability for losses—Auditors' duty to report to members—Meaning of 'members'—Companies Act, 1929, Sections 134 and 275.

This was a misfeasance summons taken out by Mr. Dudley Lewis, of Crown Court, Cheapside, the liquidator of Allen, Craig & Co. (London) Ltd., importers of chemicals and oils.

The company was registered in 1921 and the balance sheets and profit and loss accounts from 1922 to 1930 all showed losses. They were signed by two directors and by the auditors. There were also reports signed by the auditors drawing attention to the company's condition. Both the reports and the balance sheets were sent by the auditors to the secretary of the company in February, 1931. No general meeting was called. No further accounts were prepared and, in February, 1933, the company went into liquidation.

The liquidator asked for a declaration that Wilfrid Thompson Allen, managing director of the company, was liable for debts of the company contracted after 30th June, 1925. He also asked for a declaration that Edward Moore & Sons, chartered accountants, of Queen Street Place, City, were as auditors of the company liable for debts contracted after the same date.

BENNETT, J., giving judgment, said that Allen, Craig & Co. (London) Ltd.

* [1934] 1 Ch. 483; 78 *The Accountant* L.R. 25.

was a company formed with a capital of £10,000 in 1921 to carry on the business of importers of chemicals, oils and kindred products. From incorporation down to the date of the voluntary liquidation in February, 1933, the company never did anything but make losses.

The losses were:

For the year ending 30th June, 1922	..	..	£ 2,078
" " " 1923	..	..	2,130
" " " 1925	..	..	2,033
" " " 1926	..	..	3,993
" " " 1927	..	..	4,747
" " " 1928	..	..	4,589
" " " 1929	..	..	4,028
" " " 1930	..	..	3,960
For the half-year ended December, 1930	..	..	1,724

At the date of the liquidation there was a deficiency of assets when compared with liabilities of £40,813, that being subject to assets realising the amount at which they stood in the books of the company. That was a somewhat appalling state of affairs. It had been said that Mr. Allen should be regarded as an incurable optimist. 'There comes a point of time', said his lordship, 'when owing to an accumulation of evidence it would be quite unreasonable to accept such a plea as an excuse for a man's conduct.'

After auditing the accounts for the year ended 30th June, 1924, the auditors made not merely the statutory report to shareholders, but sent a long letter to the company analysing the accounts. In it they said:

'The financial position of the company is doubtless engaging the serious attention of the board; and failing the introduction of further share capital they will probably consider it desirable to convene a meeting of shareholders for the purpose of laying before them a statement of the liabilities and the assets of the company.'

That letter was discussed by Mr. Allen with the auditors, but nothing was done.

In February, 1927, the company was getting short of money and arrangements were made by Mr. Allen for the introduction of more by a man who became a director of the company, and who said that he 'was always asking his co-director Allen for accounts'.

In May, 1927, the accounts for the years 1925 and 1926 began to be prepared. With the former the auditors enclosed a letter, saying:

'It is doubtful if any value attaches to the goodwill of the business, and if the sum of £8,000 which appears in the balance sheet is excluded from the assets there is a deficiency as regards creditors on 30th June last—assuming the remaining assets realise the amount at which they are stated—of £6,981.'

With regard to the 1926 accounts the auditors wrote to say that on the same basis these showed a deficiency of £10,964.

Whether these letters were, or were not, received at the time, it was plain beyond dispute that they were in the hands of Mr. Allen by 20th December, 1929.

No other conclusion was possible than that Mr. Allen was liable under Section 275 of the Companies Act in respect of debts incurred.

The position of the auditors raised a question which was of importance, not only to auditors, but to investors.

On behalf of the liquidator Mr. Christie, K.C., expressly disclaimed any suggestion of deliberate misconduct on their part. It was only right to say that there was not a shadow of ground for suggesting such misconduct. No complaint was made of the skill with which they audited the accounts. If they were liable under the Companies Act it was merely because they did not know of the obligations imposed upon them by the Act.

Before it could be held that a man was guilty of breach of duty it must be possible to define the duty.

There was a slight difference between the provisions of the Companies Act of 1908 and the Companies Act of 1929, but in this respect he did not think the difference material. The important section was 134 of the Companies Act of 1929, which provided that 'every auditor shall make a report to the members on the accounts examined by them. . . .'

In this case the duty of the auditors could be decided by reference to the report and balance sheet for the years ending June, 1925, and June, 1926. Both were signed by two directors, and the auditors' report on both was signed by the auditors.

In respect of these two balance sheets, what was the duty of the auditors? All the auditors did with them was to send them to the secretary of the company. They never got beyond the secretary of the company. The directors never caused a general meeting of the company to be held for the purpose of considering these two balance sheets and the reports annexed thereto. So far as preparation was concerned they were finished in December, 1928. They were not signed until February, 1931.

On behalf of the auditors, it was argued that the duty of the auditors under Section 134, subsection 1, of the Companies Act, 1929, was to make a report to the members of the company. Mr. Christie argued that that was the plain wording of the section, and that the plain fact was that the members of the company never saw the reports of the auditors on these balance sheets.

Did the statute impose on auditors the duty of making their report to every member of the company? If the words of Section 134, subsection 1, were given their plain meaning it would seem that that obligation was imposed. It could not have been the intention of the Legislature to impose that duty on auditors and it certainly never had been the practice since this obligation was first imposed for auditors to send their reports to every member of the company.

Mr. Christie himself had shrunk from saying that the section imposed a duty on auditors to send their reports to every member of the company. He said 'members of the company' meant all members of the company, but that these were represented by members present in general meeting. Therefore, if the report were presented at the general meeting the duty was complied with. If, on the other hand, there was no general meeting called by the directors, then Mr. Christie argued that members of the company meant all the members, because the section did not say the words meant less.

It was a strange way of interpreting a section, to say that the words of it were to have two different meanings—one at one time, another at another. The words must have some one meaning throughout. The meaning of them could not be changed according to whether or not the directors chose to call a general meeting. It would not be possible to hold that members in Section 134, subsection 1, meant all the members, because it could not be that auditors were to be at the expense and trouble not merely of sending their reports through the post, but of delivering them to every member of the company. If the duty were absolute, sending copies through the post might not be sufficient. Therefore circumstances made it necessary to limit the meaning of the word members as found in the section. The limitation that ought to be placed upon them was 'members assembled in general meeting'.

The next thing was to decide whether the auditors were under some duty that it might be impossible for them to perform. It could not be right to say that. If the duty were to report to members in general meeting, it was not possible to say that it was the duty of auditors to make that report themselves—unless they could themselves call a general meeting or compel somebody else to call a general meeting. There were no means by which auditors could themselves convene a general meeting. Nor were there means by which they could compel others to do so. The only persons who could call a general meeting were: (1) directors, (2) members who had requisitioned the directors to call a meeting, and (3) in certain circumstances the Court. Auditors themselves were powerless.

All these considerations forced one to the conclusion that the duty of auditors, having affixed their signature to the report attached or annexed to the balance sheet, was confined to sending that report to the secretary of the company, leaving the secretary or the directors to perform the statutory duty of convening a general meeting to consider the report. It was the duty of directors to see that the auditors' report was read at such meeting.

This interpretation of the section might give rise to cases in which matters the shareholders ought to know were not brought to their attention as soon as they might be.

For example, there might be a case in which the auditors found the directors

were receiving remuneration to which they were not entitled. The auditors having stated that fact in their report and sent it to the company's office, the directors might obstinately refuse to call a meeting. In that way, the matter might be kept from the knowledge of shareholders; but after all the shareholders had their rights under the statute.

The statute compelled directors to convene a meeting of shareholders once a year. It compelled the directors to present reports to the general meeting of shareholders. It compelled the directors to have the auditors' reports read to the meetings. If the shareholders had not the will or the determination to exercise their rights that did not seem to be any reason for enlarging the duties of auditors.

Having come to the conclusion that the auditors' duty is discharged by sending their report to the secretary of the company, or the company's office, it was plain that on the facts of this case there had been no violation by the auditors of their duty.

Other matters had been argued. In particular, the question whether losses incurred by a company after auditors had failed in their duty afforded the proper measure of damage. He was quite unable to see that it did. Even if he had thought the auditors had failed in their duty he should have been inclined to say the application of the liquidator failed on that ground.

There only remained the question of the extent of the liability of Mr. Allen, the managing director. He did not propose to direct an inquiry into that. Probably it did not make much difference whether the amount of the liability of Mr. Allen was fixed at £40,000 or £20,000.

It would not be right to hold Mr. Allen liable for debts incurred before November, 1929. The sum fixed ought to be some sum which must exclude all liabilities incurred before that date. The sum of £28,300 might be taken to represent debts incurred after that date. Mr. Allen would be declared to be personally liable for that amount.

The auditors would have their costs paid by the liquidator. Mr. Allen must pay so much of the liquidator's costs as were incurred in establishing the claim against him. The liquidator would have the right to recoup himself out of the assets in respect of costs he was ordered to pay.

An order was made accordingly.

REX v. BISHIRGIAN; REX v. HOWESON; REX v. HARDY*

(Decided by the LORD CHIEF JUSTICE, MACNAGHTEN and DU PARCQ, JJ., in the Court of Criminal Appeal, on 18th March, 1936)

Criminal law—Company—Prospectus—False in a material particular.

Appeals from convictions by the Central Criminal Court for offences contrary to Section 84 of the Larceny Act, 1861.

The appellant Bishirgian, being a director of a public company, James & Shakespeare Ltd., was charged with making, circulating or publishing, or concurring in making, circulating or publishing, a prospectus which he knew to be false in a material particular with intent to induce persons to become shareholders in the said company; and the appellants Howeson and Hardy were charged with aiding and abetting Bishirgian in that crime. All three defendants were also charged with conspiracy that the defendant Bishirgian should commit the above offence. All were convicted on both counts, and Bishirgian and Howeson were sentenced to twelve months' imprisonment in the second division, and Hardy to nine months in the second division.

The facts of the cases are set forth in the following judgment of the Lord Chief Justice, dismissing the appeals:

These three appellants, two of whom are present, were convicted at the Central Criminal Court on 21st February last upon an indictment containing two counts. It may be convenient to refer to the very words of the indictment. The first count describes the offence which is charged in these terms: 'knowingly making a false statement in a prospectus with intent to induce persons to become shareholders, contrary to Section 84 of the Larceny Act, 1861'. The particulars of the

*[1936] 80 *The Accountant* L.R. 33 (C.C.A.).

offence are stated in these terms: 'Garabed Bishirgian on 3rd September, 1934, being a director of a certain public company, James & Shakspeare Ltd., made, circulated or published, or concurred in making, circulating or publishing, a certain written statement, a prospectus, which he knew to be false in a material particular, with intent to induce persons to become shareholders in the said company. Howeson and Hardy aided and abetted the said Bishirgian to commit the said offence.' That is the first count. The second is described as conspiracy to contravene Section 84 of the Larceny Act, 1861, and the particulars are these: 'Bishirgian, Howeson and Hardy, between 31st December, 1933, and 7th September, 1934, conspired together and with other persons whose names are unknown, that the said Bishirgian, being a director of a certain public company, James & Shakspeare Ltd., should make, circulate or publish, or concur in making, circulating or publishing a certain written statement, a prospectus, which he knew to be false in a material particular, with intent to induce persons to become shareholders in the said company.'

The jury, after a protracted trial, convicted the appellants on both counts of the indictment, and Bishirgian and Howeson were then sentenced to twelve months' imprisonment in the second division, and Hardy to nine months in the second division. From that conviction all the appellants now appeal.

In addition to the particulars contained in the indictment, two sets of further particulars were delivered and handed to the appellants. The first of these is a document entitled 'Particulars of omissions which made the prospectus of James & Shakspeare Ltd. false in a material particular'. It may be well to read this document, which consists of two paragraphs: (1) The prospectus states that James & Shakspeare had an option to purchase 101,000 ordinary shares of £1 each of Williams, Henry & Co. Ltd., and had the right to subscribe, after exercising that option, for 49,000 unissued shares of the same company at 25s. each. It states that it was the intention of the directors, immediately after the allotment of the shares they were offering to the public, to exercise that option and to acquire the unissued shares for a total sum of £162,250, but the prospectus, while purporting to set out the nature of the business and the assets and liabilities of Williams, Henry & Co. Ltd., omitted to state that Williams, Henry & Co. had forward commitments, at the date of the prospectus, amounting in shellac to £399,079, and in pepper to £967,046, a liability which in the event of Williams, Henry & Co. failing to meet its obligations would make the shares which James & Shakspeare were acquiring valueless. There was, in fact, no specific mention in the prospectus of either shellac or pepper; (2) the prospectus also states that it was proposed to acquire the valuable goodwill and organisation of the metal and produce department of Bishirgian & Co., but it omitted to state that Bishirgian & Co. had acted as brokers in Williams, Henry & Co.'s purchases of shellac and pepper, and that James & Shakspeare, by acquiring that part of its business, would become brokers for Williams, Henry & Co. in any future purchases which might be necessary, in view of their heavy existing commitments, for them to make in shellac and pepper in order to keep up the prices on the market, and that, in default of their principals, James & Shakspeare would be liable for such further commitments as brokers.

There followed another document which is headed in this way: 'Particulars showing how the omission in the prospectus made it false in a material particular', and this again is divided into two paragraphs. First, the prospectus is alleged to be false as a whole; and, secondly, the prospectus gave the impression to any member of the public reading it that he was being invited to invest in an old-established metal dealers' and brokers' business, which, with a view to consolidating and enlarging its business and obtaining adequate capital, desired to acquire two other businesses carrying on ordinary business in metal and commodities.

Those were the charges, and those were the particulars. It may be well also to read the section of the statute with which both counts in the indictment had to do.

Section 84 of the Larceny Act, 1861, provides as follows:

'Whosoever being a director, manager, or public officer of any body corporate or public company, shall make, circulate or publish, or concur in making, circulating or publishing, any written statement or account which he shall know to be false in any material particular, with intent to deceive or defraud any member, shareholder or creditor of such body corporate or public company,

or with intent to induce any person to become a shareholder or partner therein, shall be guilty of a misdemeanour.'

Now, our attention has been directed, in the course of the argument on behalf of the appellants, to many cases, including and antecedent to the recent case of *The King and Kysant*, reported in [1932] 1 K.B. 442.* It has been said, and said correctly, in the course of the argument, that the decision of this Court in that case lays down no new law. It merely applies to the facts of that particular case law which for a long time was well settled. The judgment of the Court begins by referring to various authorities which in the view of this Court supported the view of the law which had been contained in the summing-up of Mr. Justice Wright, as he then was.

Lord Hewart referred to a case in 1900 when Lord Macnaghten said, 'it is a trite observation that every document, as against its author, must be read in the sense which it was intended to convey, and everybody knows that sometimes half a truth is no better than a downright falsehood'.

The Lord Chief Justice went on to refer to passages from other judgments which had also been read, and continued: There can be no doubt that the law which is applicable to such a case is perfectly clear. The expression of the law varies. The meaning remains identical. If a statement is impugned under this section it is because there is such a partial and fragmentary statement of fact that the withholding of that which is not stated makes that which is stated false. Or to use other words, there must be 'such a non-disclosure as to render the document misleading', or again, in the words of Mr. Justice Eve, employed in a case to which our attention was directed, 'the non-disclosure must be the non-disclosure of something the disclosure of which would falsify some statement in the prospectus'.

Now the argument here on behalf of the Crown is not merely that that condition is satisfied, but that it is satisfied *a fortiori* where the contention is that the concealment of that which has been concealed renders the whole prospectus a lie. The case for the Crown here, as I follow it, is not that in this or that particular the prospectus which was put forward for the purpose of attracting from the public large sums of money was in some accidental or incidental way false. The case is that the very essence and function of this document was to mislead. It was a cheat from beginning to end, and the way in which the learned judge, in his extremely careful and complete summing-up, expressed the matter was plain enough for any jury fully to comprehend. He referred to the matter again and again. He put it in a very concise sentence at an early stage in his summing-up 'This document', he said, 'cannot be a false document merely because something is omitted. It has to go beyond that. The omission has to make that which is stated affirmatively untrue, untrue in the sense that it creates clearly and intentionally an impression on the public—a belief in the mind of the public—which is wrong. If it does not, there is an end of the case.'

And elaborating that statement with regard to the second ingredient in the charge, he immediately added this: 'Did the defendants know of its falsity? Here again you have to be very careful; you have got to be precise. It is not enough to say they knew of the omission. That is not enough. They have got to know and appreciate its falsity. In other words, if you are trying to describe a state of mind it must be a state of mind which amounts to this: "Yes, I know that I have omitted something that ought to be there; I appreciate that this is making my prospectus affirmatively false; and I know and appreciate that that prospectus will create a certain impression, an impression which is not true." It is not enough merely to say you are satisfied they knew of the omission. It is not enough to say you are satisfied that they knew it was an important omission. You must go further and say, "we are satisfied that they knew that this omission made that document a false document", in the way I have described to you.'

In the opinion of this Court that was a correct and fair direction upon the question of law.

The complaint which is made here by these appellants is that the prospectus—the document which is before the Court—offering preference shares and ordinary shares in James & Shakspeare Ltd., was not false in any material particulars within the meaning of the statute. The case for the Crown was that the evidence

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proved conclusively that the prospectus was false as a whole in that it gave an entirely false description of the business in which the public were being invited by the prospectus to invest their money. The public were invited by this prospectus to subscribe £300,000 for preference shares and £112,500 for ordinary shares in James & Shakspeare Ltd., a company which was carrying on, as it said, business in London as metal dealers and brokers, a business founded in 1844 and carried on uninterruptedly from that time. The prospectus stated that the carrying of stocks on the London market for account of clients is essential to the successful development of the company's business which had been retarded in the past by the inadequacy of its capital resources. Out of the total amount for which subscription was being asked—£412,500—the sum of £162,000 was to be used in acquiring a majority interest in a company called Williams, Henry & Co., a company, as it was said, with similar interests, having important agencies and connections in the United States of America, India and the Colonies. That was the only description given in the prospectus of the business of Williams, Henry & Co., and the balance of the £412,500, after providing for the expenses of the issue—a balance estimated at approximately £225,000—was to supply the additional capital resources, the inadequacy of which had retarded the successful development of the company's ordinary business.

The words of the prospectus are, 'The substantial amount of additional working capital which will now become available for that purpose, namely, the carrying of stocks on the London market for account of clients, should assist materially in extending both the volume and the scope of the company's activities.'

The contention on the part of the prosecution was that the prospectus, by that which it did state with regard to the businesses of James & Shakspeare and of Williams, Henry & Co., and especially by contrast with what it omitted to state, gave, and was intended to give, an utterly false description of the business into which at that time the public were really, though they did not know it, being invited to put their money.

Except for some comparatively minor matters there was really no dispute on the facts. The case which was made was that the persons behind this prospectus were really at this time engaged, not in ordinary business, but in a gamble, described indeed in various phrases but always the same thing; a gamble to make a corner in pepper, or control the price or to command the market. That gamble had been conducted by the company Williams Henry, a private company belonging wholly in different proportions to Bishirgian and Howeson, and they were advised by a memorandum from a Mr. Walker that inasmuch as 12,000 tons was the average annual amount of the consumption of white pepper, an interest in 2,000 to 3,000 tons would provide a decisive influence on the trend of prices. By 30th June, 1934, Williams, Henry & Co. had bought 2,460 tons of pepper, Mr. Bishirgian acting as broker for that company.

There followed on 24th July a decision to buy pepper up to a quantity of 6,000 tons. A great deal of the discussion in this Court has exhibited once more the fallacies which may arise from the mere misuse of terms. The particular term which lays the foundation for the main fallacy on which the appellants repose is the term 'future commitments'. Anybody who is at all acquainted with business and anybody who reads about these companies with intelligence may be taken to know that some future commitments there must be. So the learned judge ruled, and, indeed, it is obvious. Because they are future commitments—although no doubt they ought to be entered in a properly kept minute book—they may well fail to find a place in accounts, duly audited, and for this reason—that future commitments do not become material for the work of the auditor inasmuch as the time has not yet arrived when the commitments have crystallised either into profit earned or into a loss incurred.

The future commitments of a normal business are one thing. The future commitments of a colossal gamble are different, not merely in degree, but in kind. Sir Patrick Hastings, in his argument, developed the proposition that inasmuch as it is apparent, not from express words but from a reasonable inference, that there must be some future commitments, it is really not material for the purposes of the present case, at any rate, to examine the dimensions of those commitments. Given the fact, the quantum, it is said, does not matter. There, it seems to me, lurks the fallacy. The future commitments of a normal business are one thing.

The airy speculations of a colossal gamble are quite a different thing. It is not a difference of degree; it is a difference of kind. As the judge explained in the course of his summing-up, by using apt illustrations to make the point perfectly clear, there is not merely some difference but all the difference between future commitments of normal trade, and future commitments of an attempt to corner. The financing, as it is called, is different. The risks are different, and to advertise a business as an ordinary business seeking development when money is really being asked for to feed and supply an ambitious gamble is simply deceit.

The argument is not that in this or that particular this prospectus was untrue. The argument is that its whole purpose and effect were to deceive. It is said that no suitable words could have been included in the prospectus to repair the omission. It is not quite clear what that proposition means. If suitable and true words had been there it might well be that the prospectus would not have been of much use. Suppose there had been a note: 'N.B.—You are apparently being invited to subscribe to a well-known, old-established, ordinary business carrying on its operations on approved lines. You are really being invited to trust your money to a gambling speculation to make a corner in pepper.' It would have been the truth, but the utility of the prospectus might have been extremely small.

That was the case, and the main facts in the case, protracted as it was, are not in dispute. There may be some dispute about dates—as to the precise moment of time when the gamble began—but it was all antecedent to this prospectus, and the purpose for which this money was wanted, the purpose to which in fact this money was applied, was the bolstering up of a very ambitious scheme—which failed—to control the pepper supply of the world.

In order to ascertain the question whether this document was false in a material particular or in all material particulars, one may ask oneself this question: If the facts had been revealed, or even clearly indicated, would any man of sense have put his money into it? That question is sought in argument, and to some extent in the evidence, to be answered on the part of the appellants by the statement: 'The appellants themselves put money into it and themselves undertook large personal risks. They believed, and they said, that they were on a good thing.'

No doubt there was a time when they entertained the most sanguine expectations of this enormous operation on which, by degrees, they had entered. That does not alter the nature of the operation. The public were not told what the good thing was. The public were told that the good thing was quite a different good thing, and really when one analyses, after hearing all the argument, the excuse which is offered on the part of these appellants, it comes to no more than the excuse of the office boy who takes half a crown out of the till because he has a good thing for the Grand National.

Morally and legally the transactions are substantially on the same footing. The dimensions greatly differ. On behalf of these appellants it is contended that the judgment in the *Kylsant* case does not apply. Of course, the facts in this case are not identical with the facts in the *Kylsant* case. The question is not whether the facts are identical but whether the well-settled principles exhibited in that case apply. In our opinion, they clearly apply and apply here *a fortiori*. The rest of the argument for the appellants is that in various respects the judge misdirected the jury. I have read the summing-up more than once and I am not going to presume to apply complimentary epithets to it. It examines the facts of this case with completeness and care. It states the law with precision and accuracy.

It not only lays it down that if upon the whole sum of the matter a reasonable doubt is left in the jury's mind on the question whether the prosecution has established its case that doubt must be resolved in favour of the prisoners, but it goes further and lays it down apparently again and again that upon every question incidentally arising in the course of the case any doubt must be resolved on the side of the prisoners and any explanation offered by the prisoners must be accepted.

The appellants cannot complain of a direction like that. It is quite true that on the particular topic of conspiracy, if the words used by the judge are to be interpreted literally, he appeared to slip into the error of saying that in order to complete the crime of conspiracy the criminal act intended to be done must in fact be done.

Probably the phrasing of that particular part of the summing-up is due to the

circumstance that the conspiracy here charged was a conspiracy that Bishirgian should make, circulate, &c., a written statement which he knew to be false, and it may well be that what was in the judge's mind was that when one looked at the first count or the second count the essential ingredient was knowledge on the part of Bishirgian that the document was false. But that particular passage, relating to conspiracy, which in terms, at any rate, laid it down that unless Bishirgian did indeed commit the offence of making or circulating a false document neither of the other two could be guilty of conspiring with him, or with persons unknown, that he should make such a false statement was unduly beneficial to the appellants, unless one has to draw the inference that on that count the jury were disposed to convict the other two appellants and therefore included Bishirgian also.

The Court would be loath to draw any such inference, and the sting of that argument entirely goes when one remembers that on the first count, on which the jury also found a verdict of guilty, it was fundamental that he, being a director, should have been found to make a statement which was false.

There have been individual complaints of this or that passage in the summing-up according to the well-known and perfectly legitimate method of putting every sentence in a summing-up under a microscope to see if there is something with which fault can be found, but we are satisfied that this summing-up, taken as a whole, and one part of it being read with another part of it, was eminently fair, and that there is no ground upon which it can be alleged that there was affirmative misdirection or that kind of misdirection which consists in omission.

It is quite true that in one passage the judge, dealing with the date at which the gamble, the attempt to corner, must be taken to have started, assumed that he himself was the author of a particular suggestion. With all respect to the judge, it is by no means clear that that is correct. On the contrary, there are certain passages in the questions asked by the Attorney-General which would have been needless if it were true that it were left to the judge, in his summing-up, to suggest a particular date for the inception of the gamble.

We have listened with attention to all the individual complaints which are offered, and in our opinion there is no substance in them and there is nothing which affects the validity of this verdict. The case was amply proved, the law was clearly and accurately stated, and these appeals are dismissed.

Lord Hewart added that as leave to appeal had been given, the sentences would run from the date of conviction.

PENDLEBURY LTD. *v.* ELLIS GREEN & CO.*

(Decided by Mr. Justice SWIFT at Manchester Assizes on 17th, 18th, 19th and 20th March, 1936)

Accountancy and auditing—Private company—Claim against auditors

In this action Pendleburys Ltd., jewellers, of 14 Thorniley Brow, Danzig Street, Manchester, sued Messrs. Ellis Green & Co., chartered accountants, of Cromwell Buildings, Blackfriars Street, Manchester, claiming damages for negligence and/or breach of duty.

Mr. W. Gorman, K.C., and Mr. A. Denis Gerrard (instructed by James Chapman & Co.) appeared for the plaintiffs; Mr. Philip Vox and Mr. W. Summerfield (instructed by Wood, Lord & Co.), for the defendants.

THE PLEADINGS

The allegations of the plaintiffs, as set forth in their statement of claim, comprised the following:

- (a) The defendants were employed by the plaintiffs as auditors and accountants, the appointments having been originally made orally at the registered office of the plaintiffs, on or about 25th July, 1911, by Mr. Arthur Percy Pendlebury, Mr. Jonathan Pendlebury and Mr. James Thomas Pendlebury, and thereafter the employment was continued by the conduct of the parties—the defendants acting as auditors and accountants and the plaintiffs remunerating them for such work;

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- (b) From the relationship thus set up between the parties there was an implied duty upon the defendants, their servants and agents to exercise reasonable skill, care and diligence in the examination and audit of the plaintiffs' books, accounts and documents, and it was also implied from the fact that the defendants were accountants;
- (c) At all material times one, Hurnell, was the cashier of the plaintiffs, in sole charge and control of the books (other than the private ledger) and cash of the plaintiffs, and the defendants knew this fact because Mr. Arthur Percy Pendlebury had given them that information shortly after the 25th July, 1911, and from time to time thereafter, and also because at each audit it was apparent to the defendant;
- (d) By reason of the negligence and/or breach of duty of the defendants, their servants or agents, the plaintiffs lost the sum of £1,552 during the period from November, 1928, to November, 1934;
- (e) The defendants devised and were responsible for the system of book-keeping of the plaintiffs, and on their appointment had discarded all the then existing books of the plaintiffs; further, they had supplied to the plaintiffs the books of account, and the system of book-keeping used by the plaintiffs was as prescribed by the defendants.

The negligence and/or breach of duty alleged under (d) (*supra*) included:

- (i) Failure, in respect of each audit, to check, properly or at all, the additions of the daily cash received book;
- (ii) Failure, at each audit, to check and/or reconcile the daily cash received book with the general cash book, so that sums of money received and recorded in the daily cash received book were not entered, properly or at all, in the general cash book;
- (iii) Failure, at each audit, to check, properly or at all, counterfoil cash slips against the daily cash received book;
- (iv) Failure to observe that on sundry dates at or about the end of the audit periods Hurnell had fictitiously increased amounts in the general cash book, and that he had failed to enter in the general cash book cash received from sundry debtors as duly shown in the daily cash received book;
- (v) Failure at one audit, viz. the one immediately subsequent to January, 1929, to count, properly or at all, the cash in hand at or about the date of making up the books, and/or failure to compare cash and cheques received as shown in the cash received book with the entries in the general cash book;
- (vi) Failure to observe, at audits during the years 1929 to 1934, that the general cash book was not written up in chronological order, and/or failure to ask for an explanation thereof;
- (vii) Failure to observe, during audits from July, 1931, to July, 1934, with regard to eight items of cash, that though they were entered as having been paid to the bank during the accounting period under audit, they had not been credited by the bank until the new accounting period;
- (viii) Failure, at each audit, to check the additions of the wages book, and/or to vouch the wages book with the general cash book;
- (ix) Failure to observe that on the last day of the accounting period, at five audits, the cash sales as recorded in the general cash book were large and far above the average sales recorded for the period;
- (x) Failure to observe, with regard to the last day of each of two accounting periods, that the cash in hand was large, and failure to inquire the cause thereof;
- (xi) Failure, with regard to all the audit periods, to take any or any proper steps to vouch the accuracy of the recorded cash sales. This failure was said to be particularly serious in view of the fact that the cash sales in the plaintiffs' business constituted on an average from 34 per cent. to 55 per cent. of their total sales.

To the above allegations the defendants pleaded as follows:

- (a) The defendants acted as auditors and not as auditors and accountants;
- (b) Hurnell was the book-keeper of the plaintiffs but not their cashier; nor had he control of the books and cash of the plaintiffs; nor did the defendants at any time know that Hurnell was in sole control of the books and cash;
- (c) The plaintiffs had not lost the sum of £1,552, as alleged, or at all;

- (d) The defendants did not devise the system of book-keeping used by the plaintiffs, nor were they responsible for its adoption;
- (e) The defendants had not been negligent or in breach of duty, and in particular they had no knowledge at any time of the existence of the cash received book, nor had they had any means of knowing of its existence;
- (f) With respect to two audit periods, during or subsequent to the preparation of the balance sheet and the profit and loss account, the attention of the plaintiffs was specifically called by the defendants to defects in their system of book-keeping in consequence of which there was no check upon cash sales and, in fact, the defendants had not checked the cash sales; the attention of the plaintiffs was called to these points by Mr. Ellis Green, the principal of the defendant firm, and by Mr. Roger Heap, an audit clerk in his employ—in both cases orally; and subsequently to those notifications the plaintiffs always knew that the defendants were neither able, nor had they purported, to check the cash sales;
- (g) The defendants neither knew, nor had they any means of knowing, at any time, of the existence of the wages book;
- (h) The defendants, during each audit, when forwarding the draft balance sheet to the plaintiffs, sent therewith a covering letter with a list showing items which had not been vouched by them, which list always included (amongst others) the item 'wages'.

EVIDENCE FOR PLAINTIFFS

Mr. J. T. Pendlebury stated that he was the eldest of the three brothers (J. T. Pendlebury, A. P. Pendlebury, and J. Pendlebury); he had founded the business in 1887; after some years he had taken his two younger brothers into partnership with him, and the business was conducted as a partnership firm until 1911. Having known Mr. Ellis Green for some considerable time, he had invited him to carry out the work of forming the business into a private limited company. Mr. Ellis Green, he added, doubled the number of books which the partnership had used, introduced a new system of books with which the company had ever since carried on, and, in fact, he had bought the actual books used originally by the company and had opened them. After the formation of the company he (Mr. J. T. Pendlebury) took a declining interest in the business, leaving his brother, Mr. J. Pendlebury, in charge of the workshop (which constituted the upper part of the company's premises), whilst to Mr. A. P. Pendlebury was assigned the duty of taking charge of the warehouse jointly with Hurnell; the company carried on both a wholesale and retail business, and so far as cash sales over the counter were concerned Mr. A. P. Pendlebury attended to them as well as Hurnell, but Hurnell had all the books and had charge of all the cash. The books (other than the private ledger) were in the handwriting of Hurnell, as were also the (carbon) copies of the slips contained in the manifold books used for recording cash sales—the other (top) copy in each case had been handed to the customer as a receipt or acknowledgment of his purchase.

In cross-examination by Mr. Philip Vos, he admitted that Hurnell had been employed by the company, and prior thereto by the partnership firm, and by himself, as original sole owner of the business, for a total of nearly forty years; he had always been regarded—down to the date of his death in November, 1934—by all the three brothers as a man whose honesty was beyond all doubt. 'I signed the balance sheets, whatever it was that was placed before me; I was content to leave it to the auditors to see that it was in proper form.' Some of the entries in the books were in the handwriting of Mr. A. P. Pendlebury, but those would be items arising during the temporary absence of Hurnell, for example, at meal times. He further admitted that the cash was kept in an unlocked till; that out of that till Mr. A. P. Pendlebury would take cash in order to pay clients of the firm who sold to Pendleburys old gold and silver; he himself had on a few occasions likewise taken cash, but Hurnell's permission was always sought and the matter was done with his knowledge. He thought that the auditors must have seen the cash received book and the manifold slips books, because they were always on a small desk near the counter; it was only after the death of Hurnell that Mr. A. P. Pendlebury discovered that the company's books of account appeared to be not properly kept.

Arthur Percy Pendlebury, a director and secretary of the company, declared that the system of book-keeping introduced by Ellis Green & Co. on the incorporation of the company had remained unchanged throughout. Apart from some questions relating to debenture interest, the audit clerks employed by the defendants had never sought information from him in the course of their audit work. If he had occasion to take cash from the till when Hurnell was absent, he had always placed a note on the latter's desk and later explained the matter to him. The audits had been carried out at a desk which adjoined the sales counter, and was separated from it only by a small screen. 'It was in January, 1935, that my suspicions were aroused that all was not well with Hurnell's books. I spoke to Mr. Dawes, one of the defendants' clerks, and then pointed out to him that his firm had apparently never taken any notice of the cash received book.'

Cross-examined, he denied that he knew that until 1923 the defendants had prepared the company's income-tax returns, and that although the defendants were willing to continue to do this work as well as the auditing without any extra fee, the company had instructed them no longer to prepare the returns; he admitted that as secretary to the company he had, in fact, signed the income-tax returns which were made. He had told Mr. Brownlow, another of the defendants' clerks, that he had made a regular practice of checking the cash each day, but that was after Hurnell's death.

Mr. Vos: Is there anything in the cash received book to show whether any particular item related to cash paid or cash received?

Witness: All the items relate to cash received.

Mr. Vos: The actual book which is produced bears upon the outside cover, in gilt lettering, the words 'Day Book'; I observe that a slip of paper has been pasted above that lettering, bearing the words 'Cash Received Book, 1929-1932'. That book received its name 'Cash Received Book' only when Mr. Elliott, a clerk in the employ of Messrs. Harvey, Longrigg & Crickett, chartered accountants, who has investigated your company's books since the commencement of these proceedings obtained it for the purposes of his investigation? That is the true position is it not?

Mr. Vos (continuing): Do you say that all the items in the book are cash received? What about those which are marked 'a/c'?

Witness: That is cash just the same; it represents transactions with customers who have an account with the company.

Mr. Vos then put to the witness a number of entries in the general cash book which, apparently, indicated that items paid to the company during the half-year covered by a particular audit were brought in as receipts only at the end of that audit period.

The witness: With regard to items which would properly be found in the private ledger, I entered them in the private ledger at the proper time, and Hurnell always knew that the entries had been so made.

George Henry Elliott stated that he had checked the daily cash received book with the relevant counterfoils in the manifold slip books for a number of periods (taken for testing purposes) spread out over four years, and as a result of his tests and investigation he had come to the conclusion that the cash received book was a correct book. The cash recorded in the general cash book was less in total than the cash recorded in the daily cash received book, the difference in the totals being £1,557. (The difference as claimed by the plaintiffs in their statement of claim was, actually, £1,552.) In his opinion, if an audit started with the general cash book it would not be possible to maintain a check upon the cash transactions, and in a business of this type where the cash sales might reach so high a proportion as 55 per cent. of the total transactions, in the absence of an internal check it was essential that the auditors should make numerous tests of the cash sales of the business.

In reply to a question by the learned judge, Mr. Vos said his case was that none of the defendants' clerks had ever seen the daily cash received book; it had never before those proceedings were begun been suggested that such a book was in existence; it appeared to have been kept merely as a rough memorandum book; whatever else it might be it was certainly not a systematic, complete or exclusive record of the cash sales.

Continuing his evidence, Mr. Elliott stated that entries in the general cash

book not being in chronological order indicated that the book had not been written up at the time and, therefore, the entries must have been either posted from some other book or entered by a writer who relied upon his memory. 'If I had been adding, those circumstances would have caused me to ask questions to get some explanation as to the wrong order of dates.'

Cross-examined by Mr. Vos, Mr. Elliott agreed that an account of a smelting firm who had apparently been dealing with the plaintiff company for very many years did not appear in the ledgers, but, he added, the directors of the plaintiff company were aware of that fact and treated the transactions with that firm as cash sales. 'If the cash sales had been checked by the defendants the omission would have been discovered.'

Mr. Vos: It is part of my case that if particular matters of this kind are kept secret from the auditors, and the directors of the company are aware of the position, there are irregularities in the books which not even the most prudent auditor in the world could be expected to discover.

Continuing, Mr. Vos put it to the witness that his investigation must have revealed many items of cash received which, though they appeared in the general cash book, did not appear in the daily cash received book.

The witness: Yes; over the period of six years in question in this case I have found 101 items, out of 25,500 items in all, amounting to £282; but I did not attach any great significance to them, because they might be accounted for by clerical errors. I do not deny that there are a large number of items which, appearing in the general cash book, agree with the sales ledger, although the corresponding entries in the daily cash received book are in excess of those amounts.

Mr. Harvey Longrigg, F.C.A., a principal in the firm employing the last witness, said that he had himself also investigated some of the books of the plaintiff company. 'In a business of this kind if there are any leakages they usually are to be found in the non-recording of cash sales and in the wages. In my view, it is not proper for an auditor to give a certificate in the form in which the defendants gave their certificates unless he has conducted an investigation of the cash sales. A proper audit cannot be begun with the general cash book in a business of this kind; it is necessary to have before you all the books and all the vouchers, and if I were conducting the audit I should vouch the cash receipts; if no check is available of the cash sales, I should give only a qualified certificate.'

Mr. Vos: Suppose you had not known of the existence of the cash received book, but you were aware of the existence of the slips?—I should select a quantity of the slips and make a comparison with the general cash book.

Asked what features of the general cash book he suggested ought to have aroused the suspicion of the auditors, Mr. Longrigg replied: '(a) There are items appearing which are not set forth in chronological order; (b) there are items purporting to have been paid into the bank which, in fact, were not paid in until the next audit period; (c) the balances at the end of the audit periods seem to be unduly heavy.' He would not like to commit himself as to what would constitute a reasonable fee for an audit of this kind. 'What the defendants did was correct in a major degree; the objection is that they omitted work which ought to have been done—for example, the vouching of the cash sales.'

Mr. Vos: What if there are no vouchers?—The auditor should insert a note to that effect in his report.

Mr. Vos: If a company has three directors who are also the sole shareholders, do you say that it is essential that the auditors, if they have already reported defects to the directors, must also report them to the shareholders?—Yes.

Mr. Vos: How many times have you done so yourself?—Three times during the last six months.

Mr. Vos: That is to say, since this case started or since your firm began to investigate the books after the case started?—I have also acted upon that principle before this case started.

Mr. Vos: In how many cases?—Not many, I admit, but I can recall at least two instances.

THE DEFENCE

Mr. Vos, in opening the case for the defendants, said that Mr. Ellis Green had attended the first board meeting of the plaintiff company, at which his firm had

been appointed auditors, as appeared from the duly recorded minutes. The defendants neither purchased books nor prescribed books for their clients: they simply allowed their clients to continue the system of book-keeping which had been in operation prior to the incorporation of the company, although they had by no means shut their eyes to the defects of that system and, indeed, it would be shown in evidence that the defendants had specifically drawn the attention of the directors, over and over again, to the fact that there was no check possible on the wages and that there was no proper internal check; the audit programmes and notes would be produced, showing records made at the time, which proved that Mr. Green had himself personally taken up the various matters with the directors; the latter had replied that they were quite content with their system and were not prepared to alter it. 'If clients have been repeatedly warned by their auditors that their book-keeping system is defective, it does not lie in their mouths to come before a court of law and claim: "You have been negligent, and the result of your negligence is that we have lost a sum of money which we now claim from you by way of damages." The financial records of the plaintiff company are in a hopeless condition because of the methods adopted by their directors, who took, and permitted the taking of, money from the till, telling the cashier afterwards; further, they declined to alter a system which made no differentiation in the books as between purchases and sales. Even if the plaintiff's own evidence is to be relied upon there is no indication whatever that Hurnell did defraud them; the only possible explanation would be that he had paid sums into the bank for the purpose of deceiving the auditors. The evidence will deal particularly with a specific transaction, by way of illustration of many remarkable transactions, in which it appears from one of the books that the company received a substantial cash payment, although when the transaction was traced through the various entries it would appear that, in fact, the company had not received a penny piece; there had been, in effect, an exchange of goods.' He submitted that there was no legal duty resting upon auditors which compelled them to inform the shareholders that they were dissatisfied in cases where their criticism was directed, not to the estimated value of the assets of the company, but to its internal machinery; in this case, the plaintiffs themselves had not alleged by their statement of claim, amongst their numerous particulars of negligence, a failure to report to the shareholders the lack of internal check which the defendants had noted, beyond all possible doubt, in their communications to the directors, as appeared from the correspondence files.

Mr. Ellis Green, called by Mr. Vos, stated that he had been in practice as a chartered accountant since 1908. A member of the Manchester City Council and Chairman of the Watch Committee, he had been Lord Mayor in 1931-32. 'I have known Mr. James Thomas Pendlebury, the chairman of the plaintiff company, for upwards of thirty years, and my firm, on their original appointment as auditors, agreed to a fee of five guineas for each half-yearly audit—including the preparation of the income-tax returns—because the matter was a friendly arrangement in view of my personal friendship with Mr. J. T. Pendlebury.' In 1920, he proceeded, the fee was raised to seven guineas for each audit, and that arrangement continued until the early part of 1935, when the present proceedings were launched; in 1923 Mr. Arthur Percy Pendlebury, the secretary of the company, notified his firm that in future they preferred to prepare their own income-tax returns. 'At no time did we purchase books of account for the plaintiffs, nor did we ever prescribe any system of book-keeping.'

Mr. Vos: Does any record appear in any of your own books which would indicate that you had purchased for, and supplied books of account to, the plaintiff company?—No; I ought to make this clear, we did provide a combined register of shareholders, directors and debenture-holders, and a minute book.

Asked to state what books were available to the auditors, Mr. Green said: There was a general cash book, sales ledger, nominal ledger, and a private ledger. From those books it was possible for us to see what, at any given time, was the true financial position of the company; there was no real difficulty in an auditor giving his certificate as we did from the material available, for it comprised a complete set of double-entry books.

Dealing further with the terms of the employment of his firm, witness explained that, apart from the appointment in the first instance recorded in the minute book,

the relationship was continued merely by verbal arrangement, but it was never altered so as to include accountancy as well as auditing.

Asked his view as to whether any deduction could be drawn from the amount of the fee as to the nature or extent of the duties undertaken by a firm of accountants, Mr. Green said that a small or nominal fee, as in a case of this kind, would indicate that the accountant was undertaking to do merely the minimum amount of work necessary to comply with the statutory requirements. He then described the system followed by his firm in connection with this audit, thus: The audit has always been carried out by two members of my staff, namely, a senior audit clerk and a junior clerk. The audit clerk prepared the draft balance sheet and profit and loss account, and this was then checked in my office by another senior member of my staff. After this checking, the balance sheet and profit and loss account were brought to me, and I finally passed them, after making such adjustments as I thought necessary. The draft balance sheet, in each case, shows a rubber stamp bearing the initials, first, of the audit clerk, secondly, of the examining clerk, and, thirdly, my own initials. During the whole of the period covered by the statement of claim I have employed one and the same clerk to act as examining clerk, and he is a chartered accountant.

When I inspected the audit note-book in connection with the first audit we undertook, namely, for the half-year ended 10th January, 1912, he continued, I observed that the wages book had not been vouched; we took the matter up with the plaintiffs and received an explanation which appeared to us to be satisfactory as to why they did not choose to keep a wages book; the vouching of the wages book had been included as an item of the audit programme, written out in the audit note-book; this programme has been written out in the note-books each half-year throughout, but, after the explanation given to us at the first audit with regard to the wages book, the vouching of the wages book was eliminated from all subsequent audit programmes; we did not, in fact, thereafter undertake to vouch the wages book. In all the audit note-books a note appears showing that the wages have not, in fact, been vouched. In the audit papers for the second audit period, namely, for the half-year ended 10th July, 1912, there appears a note in the handwriting of one of my clerks dealing with the 'lack of internal check', comprising references to: '(a) Wages not signed by director each week; (b) cash sales not checked; (c) cash not balanced and checked weekly by director.' I myself called the attention of the chairman to these specific items, as appears by the note in my handwriting, made at the time, appended to my clerk's observations.

It has for many years been my practice, Mr. Green added, to submit a list of missing vouchers at the conclusion of each audit, and in this case the list shows the items 'Wages' and 'Material'; 'material' in this business relates to cash purchases of jewellery and old gold over the counter, made by the company. We found that the daily total of cash received was entered in the general cash book as one item, and this single item we could not investigate further in view of the plaintiffs' own repeated assurance that they were satisfied with the existing check upon cash. The audit note-books show, also, that on many occasions expenses have been charged by the directors, in respect of which there are no vouchers. Numerous lists of missing vouchers are in Court which show that we obtained the signature of one or other and sometimes even of all three directors to them. As an example of the way in which we notified the directors of defects in the system which we discovered, I instance a letter addressed to the company, under date 21st January, 1919, specifically calling the attention of the chairman to a cash shortage of £56 11s. 9d. which we had discovered. Again, on 10th July, 1919, there appears a note in the audit notes, in the handwriting of the clerk in charge, made at the time in the ordinary course of his duty—'Cash £87 6s. short. Saw Mr. J. T. Pendlebury on this and he said it is quite all right.' The witness then proceeded to detail numerous other instances indicating how the attention of the directors had been called to various defects.

Cross-examined by Mr. W. Gorman, K.C., Mr. Green said that if a business of this kind used a cash register and the cash sales were posted as one item, an auditor would probably examine, by testing, the record slips of the cash register itself.

By the learned judge: Could an auditor check the cash sales in a business of this kind in the absence of a cash register or some similar device?—He could not.

The learned judge then observed that one of the manifold books containing

cash slips, which had been produced to the Court, appeared to contain more letters than slips, and it was unfortunate that all the others were destroyed, as learned counsel for the plaintiffs had stated.

In answer to further questions, the defendant said that he did not take stock, and added that his certificate made no reference to stocks or materials.

After further observations by the learned judge, Mr. Arthur Percy Pendlebury was recalled; he stated that, although as secretary of the company he signed the income-tax returns, he really understood practically nothing about them, and signed what was put before him by Hurnell. He admitted that the private ledger had always been written up by himself, but added: 'I am not an accountant; I do not understand book-keeping.'

The judge: I should be interested to see some income-tax returns of this company, (a) prior to, and (b) subsequent to, the year 1923, when, as we have heard, the defendants, at the request of the plaintiffs, ceased to prepare the returns; I should like to have produced, say, three returns in each of those periods.

Mr. W. Eccles Thompson, F.C.A., of Messrs. Edwin Guthrie & Co., chartered accountants, of Manchester and London, the next witness for the defence, said: It is not possible to provide a complete internal check on the cash sales of a retail business by book-keeping alone. He then proceeded to describe systems in vogue in this country and in the U.S.A. with regard to daily checking of stock and cash in retail businesses, and explained the difficulties which had been encountered in various systems which had been tried: 'Some are applicable and practicable for special kinds of businesses, but in many cases they have been found to be too cumbersome. The general system of check in vogue in this country includes books of dockets, which are initialled by an assistant other than the one who carries out the cash sale transaction, and by the cashier, and it is not an absolutely complete check even where a cash register is installed.'

Mr. Herbert Sutherst, A.C.A., a partner in the firm of Litton, Pownall, Blakey & Higson, stated that he had formerly been in the employ of the defendants and in that capacity had been engaged on the plaintiffs' audit for some of the audits discussed in this case. He had never seen a cash received book, but he had observed that the cash was kept in an unlocked drawer under the shop counter. 'If during the course of my audit work, I had heard anything of a cash received book I should certainly have made a note of it in the audit note-book. If, for the purposes of the audit, I ever required any information, I invariably put my query to one or other of the Pendlebury brothers. I do not agree with the evidence of Mr. A. P. Pendlebury that queries (except on unimportant questions of detail) were ever referred by me to Hurnell.'

COUNSEL'S SUBMISSIONS

In his final address, Mr. Vos, for the defendants, contended that the evidence indicated quite clearly that an effective check on cash sales made over the counter, in a business of that kind, could only be achieved by the existence of an internal check system comprising either a second person to check the records of sales made by the salesman, or some mechanical check; if there was only one salesman in charge of the sales operations and counterfoils were used, it was impossible to prevent fraud if that salesman were fraudulently minded. Even if the auditors had known at the time of their audits what was now known to everybody as a result of the investigations made prior to and in the course of the proceedings at the trial, it was impossible to argue that the auditors would not be justified in saying that the books of the company correctly recorded its true financial position to the best of their information; and in those circumstances the auditors would be justified in certifying as they had done. Assuming that there was no dishonesty—and upon the evidence before the Court the auditors were justified in making that assumption—they were honestly in a position to say that the balance sheet correctly exhibited the company's financial position. Whenever information had been required they had applied to the proper officers of the company and they had been given satisfactory answers. The foundation of the charge against the defendants rested upon the lack of a proper internal check; but they had drawn the attention of the directors to this. As to the alleged loss, there was no proof of it; the general cash book conformed with the other books but the cash received book did not; and unless the cash received book was an accurate

record of the cash received there was no proof whatever of the alleged loss. The dockets produced indicated no proper system operated by the plaintiff company, and it had been shown in evidence that there were items in the cash received book as to which no entries appeared on the counterfoil dockets.

He relied upon 'the well-known old cases which are still good authority in law', viz., first, *Re London & General Bank (No. 2)* ([1895] 2 Ch.D. 673, C.A.); secondly, *Re Kingston Cotton Mill Co. (No. 2)* ([1896] 2 Ch.D. 279, C.A.); and, thirdly, *Re City Equitable Fire Insurance Co. Ltd.* ([1925] 1 Ch. 407, C.A.), and he referred more particularly to the following:

In the 1895 case it was said by Lindley, L.J. (at pages 682 and 683), that the object of the appointment of auditors is:

'to secure to the shareholders independent and reliable information respecting the true financial position of the company at the time of the audit. . . . It is no part of an auditor's duty to give advice, either to directors or shareholders, as to what they should do. . . . An auditor has nothing to do with the prudence or imprudence, for example, of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably. . . . The business of an auditor is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question, how is he to ascertain that position? The answer is, by examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books themselves show the company's true position. He must take reasonable care to ascertain that they do so. Unless he does this his audit would be worse than an idle farce. Assuming the books to be so kept as to show the true position of a company, the auditor has to frame a balance sheet showing that position according to the books and to certify that the balance sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company. If he did, he would be responsible for an error on his part, even if he were himself deceived without any want of reasonable care on his part, say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this. Such I take to be the duty of the auditor; he must be honest—i.e. he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient, and in practice I believe business men select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary; but, still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.'

In the 1896 case there occurs the oft-quoted dictum which, even if hackneyed, is always a safe and certain guide to the auditor, viz.:

'An auditor is not bound to be a detective, or to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.'

Thirdly, in the 1925 case it was pointed out:

'that the measure of an auditor's responsibility depends upon the terms of his engagement. There may be a special contract defining the duties and liabilities

of the auditors. If there is, then that contract governs the question. The articles will, however, be looked at if there is no special agreement, because the auditors will presumably have taken their duties upon the terms (among others) set out in the articles. That is not to say that auditors can set aside a statutory obligation. No agreement or article of association can remove an imperative or statutory duty.

Mr. Vos submitted, further, that upon the basis of the provisions laid down by the Companies Act, 1929, viz. as contained in Sections 122, 123 and 134, it was apparent that the auditors had done that which they were required to do under statute law, and that which their contractual obligations towards the plaintiffs required them to do, and that they had omitted nothing which they ought to have done.

In replying for the plaintiffs, Mr. W. Gorman, K.C., laid stress upon the significance of the 1925 case in which the 1895 and 1896 cases were comprehensively reviewed by the Court of Appeal; Warrington, L.J., had there summarised the matter (at page 520) by stating that:

'the duty of the auditor is to verify the facts which it is proposed to state in the balance sheet, and in doing so to use ordinary and reasonable skill.'

The question in this case, as in all cases where auditors are charged with negligence, was whether upon the particular facts adduced in evidence it could be said that the auditors had displayed reasonable and ordinary skill. He submitted that the defendants had failed to attain that standard and that, accordingly, the plaintiffs were entitled to judgment.

JUDGMENT

In delivering judgment, Mr. Justice Swift reviewed both the statute law and the common law duties of auditors, and said: The auditors were there merely to see that the balance sheet correctly recorded the position in compliance with the statutory formula and requirements, and that the books of the company were apparently properly kept. In arriving at my judgment, I rely upon the particularly lucid judgment of Lopes, L.J., in the 1896 case (at pages 288, 289) (*supra*).

The function of an auditor, the learned judge continued, is to protect the shareholders, but one must have regard to the constitution of the particular company in relation to which he acts as auditor. He is there to see that the shareholders get a true representation of the finance of the company as disclosed by its books; this he must do with reasonable care, but in considering whether or not he has displayed reasonable care one must apply rules of common sense. There is all the world of difference between a company which has a large body of shareholders numbering, say, six or seven hundred, and a company which has only three shareholders, all of whom happen to be the sole directors and the sole debenture-holders. The position of an auditor must be different when his duty is to vouch the information which he gives to a large body of shareholders, as against his position when he is criticising the affairs of the company to the three men who alone are interested in the company and who hold its every pecuniary interest. In the case of the company with a large body of shareholders, he has the responsibility of watching the directors in order that those outside people may be properly informed, for they rely upon him to keep watch on their behalf; but where the interests of a small company are confined to a very few persons, and there are no outside people because all the interests in the company are held by the directors themselves, if the auditor has, in fact, reported to the directors what more could he be expected to do?

I am quite satisfied upon the evidence adduced before me that the fact that there was no internal check on the cash receipts was brought by the defendants to the notice of one or more of the three directors of the plaintiff company, not on one occasion but repeatedly. I am not at all satisfied, and it certainly was not proved in evidence, that the deceased cashier had committed any fraud at all. If the Pendlebury brothers had taken money from the till, there was nothing wrong in that; it was their own money; they were entitled to do with it as they pleased; they were not bound to impose any check other than that which seemed right and proper to themselves, and if the existing checking system was satisfactory to them and they told the auditors so, the latter were under no further obligation with regard to it.

Finally, I would observe that the evidence of Mr. G. H. Elliott, who was called in by the plaintiff company to investigate its books when these proceedings were launched, has been given admirably; the careful researches which he has made have been of the greatest possible help to his clients, and they have been most helpful also to me. He brought to bear upon his scrutinising labour the highest degree of professional good sense; and the schedules which he has prepared and produced to me, showing the differences between the daily cash received book and the general cash book, with the resultant total difference of £1,557, have been most illuminating; but nothing could have better illustrated the wisdom and applicability of the dictum of Lopes, L.J., in *Re Kingston Cotton Mill Co. (No. 2)* where he said that 'an auditor is not bound to be a detective. . . . He is a watchdog but not a bloodhound'. The defendants have acted towards the plaintiff company in the relation of watch-dogs; Mr. Elliott, on the other hand, has acted as a bloodhound; he was called in for that very purpose; he was called in 'to be a detective' and 'to approach his work with suspicion or with a foregone conclusion that there is something wrong'.

There must be judgment for the defendants with costs.

*In re S. P. CATTERSON & SONS LTD.**

(Decided by BENNETT, J., in the Chancery Division, on 10th February, 1937)

Company—Audit of accounts—Duties of auditor—Allegation of negligence

By this summons Mr. H. D. Bell, chartered accountant, liquidator of S. P. Catterson & Sons Ltd., electric lamp and appliance dealers, alleged that Mr. C. R. Beeby, chartered accountant, was negligent in his duty as auditor to the company and claimed £1,000, or alternatively £508, or some smaller sum as compensation on the ground that in consequence an employee of the company was able to misappropriate money belonging to it which was irrecoverable.

The negligence alleged was not against the respondent personally, but against a member of his staff who did the work.

In his defence respondent denied that he was the company's auditor, but said he was engaged to make a partial audit for Inland Revenue purposes and to prepare monthly trading returns, and that he never conducted a complete audit. He also said that he warned the directors of deficiencies in their accountancy system, and he pleaded the Statute of Limitations.

In giving judgment for the respondent, Mr. Beeby, Bennett, J., said: This is a summons in the winding-up of S. P. Catterson & Sons Ltd., taken out by the liquidator, to which the respondent is a Mr. Beeby, who was the auditor of the company, in which the applicant seeks to make the respondent liable for misfeasance by the respondent in the discharge of his duties as the auditor of the company in respect of the four years 1929, 1930, 1931 and 1932.

The company was one which was established many years ago. It was incorporated on the 17th August, 1893, and it went into voluntary liquidation as a result of a special resolution passed on the 22nd March, 1935. It was a private company, and I suppose it had become such in the course of its existence, because, if my recollection is right, there were no such things as private companies in the year 1893; but it is alleged in the points of claim that it was, at the time of its liquidation, a private company.

The misfeasance arises because it is alleged that the respondent was negligent in failing to discover that a man of the name of Spicer, who was in charge of the company's showroom from January, 1929, until November, 1932, was misappropriating the moneys of the company. There is no question but that Spicer did, during the period of time for which he was manager of the company's showroom, misappropriate sums of money for which he was accountable to the company, and it has been proved or admitted that in the course of the period during which he was the manager he misappropriated at least £250. The case is that the auditor was negligent in failing to discover the fact that Spicer was a dishonest man.

I think it is as well to get one's mind quite clear at the beginning of the consideration of his responsibilities in a matter such as the present, as to what are the duties of an auditor to a company. I am not going to lay down any general

* [1937] 81 *The Accountant* L.R. 62.

rule about the duties of the auditor of a company, because I do not think it is necessary to do so, but the first fact which seems often to have been lost sight of is that the primary responsibility for the accounts of a company is with those who are in control of the company, that is to say, the directors; and in the case of the directors of this company they were not a satisfactory team. The evidence of one of them, the managing director, about his colleagues was to this effect: He said that the company was always a family concern, and that some gentlemen of the name of Catterson, the directors, all took part in the business; that they were whole-time men, and that he found them a nuisance. He said that they were very unbusinesslike that they were very obstinate in dealing with each other, that he had at one time to threaten resignation, and that he regarded one of them as impossible; and he said that for years the auditor, the respondent in this case, was reprimanding the Cattersons for their lack of business ability, that he was constantly urging them to put their house in order, and that they were refusing, he said, to give effect to any of the recommendations which Mr. Beeby, the respondent, from time to time made. Mr. Seager, the managing director, also said that although he was the managing director his colleagues frequently did things without consulting him or giving him any information as to what they had done.

Now that was the kind of board which was directing this company of which the respondent was the auditor. It is their duty in the first place to keep the company's accounts and to prepare the accounts which have to be submitted, according to the Act of Parliament, the Companies Act of 1929, to the company in general meeting. The auditors' duties are, in broad terms, prescribed by Section 134 of the Act. They have to make a report to the members upon the accounts examined by them, and upon every balance sheet laid before the company in general meeting during their tenure of office, and the report is to state whether or not they have obtained all the information and explanations that they have required, and whether in their opinion the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.

Of course, they are not confined merely to an examination of the books of account. They have got to verify them. Various judges at various times have stated what, in respect of particular matters, the auditors must do or need not do. It is important to have in mind, I think, that it is for the directors to manage the business in the way in which they think best in all the circumstances of the case, including in the management of the business the system of accounting to be employed.

Now the only complaint that is made against the auditors is in respect of their dealing with the accounts relating to the company's showroom, a comparatively small part of the company's business, a department in which 3 per cent. of the company's business was transacted. As I have said, of that department Spicer was the manager from 1929 to November, 1932, when the fact that he was misappropriating the company's money, and had been misappropriating the company's money, was discovered by the managing director as a result of a proper check of Spicer's takings being made, I should imagine for the first time during the time that he was in charge of the department, by a nephew of one of the directors, who was told by the managing director to go and do what the director ought to have done during the past three years, but which he apparently did not do, because he did not think that Spicer would like it. The directors having done their duty for the first time, Spicer's defalcations were discovered, and Spicer left his keys on the table in the office or the room in which he was employed, and has never since, apparently, been traced. That was in 1932.

The respondent was appointed auditor by the company in the year 1933; he was appointed auditor by the company in the year 1934; the liquidation overcame the company in 1935, and it was in July of 1936 that this summons charging the respondent with misfeasance was issued by the present liquidator.

It is not unimportant, I think, to have in mind in arriving at a conclusion as to whether or not this auditor has been guilty of the misfeasance with which he is charged, that the acts of negligence alleged against him were committed many years ago, in 1930, and we are now in the year 1937. It may not be easy for a man in 1937 to be able to explain his conduct in 1930. I think most people might find

some difficulty in being able to account for everything that they did five or six years ago. It is a matter not to be lost sight of.

Another matter not to be lost sight of is this, that once a fraud has been discovered, it is extraordinarily easy to see indications of it sticking out everywhere, once it has been discovered, indications which are not always apparent, or not necessarily apparent, to a man who is dealing with another on the footing that that other man is not a dishonest man. An auditor, to use the words of the late Lord Justice Lopes, is merely a watch-dog; he is not a bloodhound.

All the negligence is in connection with the checking by the auditor of the cash received by Spicer in the company's showroom. The audit was conducted during the relevant period, not by the respondent himself, but by a senior audit clerk of his, a man of the name of Flutter, who has been in his employment for very many years, and has been engaged in the audit of the accounts of this particular company for very many years, and although the legal responsibility for negligence rests upon the shoulders of the respondent, the person who was actually guilty of the negligence, if any there be, is the man Flutter, because he was in charge of these audits during the relevant period.

Now there is another matter which I think it is also as well to have in mind in judging a question such as that which has to be judged here, where the negligence arises in respect of faulty checking of cash receipts. It is a matter which rather surprised me; I suppose it ought not to have done so, but it did and it is this, that there is no fraud-proof system of checking cash receipts which is not far too complicated and cumbersome for anybody to use. If a man is dishonest in receiving cash, it is always possible for him to be able to steal for a time.

Now the system in this case in connection with the showroom at the relevant period was one which was designed for a trade in which what was sold was sold for ready money. The salesman was provided with invoice books, as they are termed, books in which each page had a duplicate, two duplicate pages bearing consecutive numbers, and when a sale was effected on the first two pages the salesman would make a record of the transaction, there being between the top page and the duplicate of it a sheet of carbon. The record of the transaction should contain, and did contain, the date of it, the customer's name, the details of it, and the amount that had been paid for the goods that were being sold. The top copy of the record should be receipted and handed to the customer, the duplicate remaining in the invoice book. That was the foundation of the liability of the salesman to account for the money, and it springs from that book, and that record in the invoice book. The duplicate shows that he is able to account for the money recorded on the duplicate as having been received in respect of the sale.

The next step in the system was, day by day, to make a record of those transactions in the daily sales cash book, the record being one in which, with respect to each duplicate invoice, on each line of the book, under the date in question, the number of the invoice was recorded, and then the amount that the salesman had received. From those entries in the daily sales cash book, at whatever was the fixed accounting period, somebody had to add up the total of the amounts so recorded, and the total of the cash recorded in that book as having been received was handed over by the manager to (in this case) a director of the company, either a Mr. James Catterson or a Mr. W. P. Catterson; and the practice of the director who received from the salesman the amount shown by the book to be due from him was to make a note, which is called a reconciliation statement, which is really a statement as to the shape which the cash takes, that is to say, the number of notes, if notes there were, distinguishing between their denominations, the coin, and, if cheques were received, the cheques. The next stage of the accounting process was this, that that was recorded in the general cash book of the company, and from there paid into the bank or traced to the bank.

Now, if all the transactions in the showroom had been transactions for ready cash, and the salesman had done his duty in making out the invoices, and had carried out the next step correctly of entering in the cash book from the invoices the amount which the invoices showed to have been received, if the entries in the cash book had all been correctly added up, and the recipient from the manager of the showroom had seen that the invoices were all correctly entered into the daily sales cash book, the check, as it seems to me, was as nearly perfect as it

could be. It would have depended upon two things, the accuracy of the salesman making the entry, and the director checking the cash book with the invoices to see that he was getting the correct sums of money from the salesman.

But unfortunately, instead of those invoices being used exclusively for ready-cash transactions, they were also used for short credit transactions; they were used for recording sales to tradesmen who did not find it convenient to pay at the moment they had got their goods, and wanted a short credit. All those transactions were recorded in these invoice books, instead of being recorded, as I have no doubt they ought to have been recorded under a perfect system of book-keeping, in some credit day book. The method employed for distinguishing the cash transactions from the credit transactions was that of turning up, in the invoice book, the invoices in respect of which credit had been given, so that in every invoice book, as well as the duplicate invoices recording transactions which had been carried out on a ready-cash basis, there would be at any given moment a number of turned-up invoices recording transactions in which goods had been sold for short credit. Then, when the person to whom credit had been given paid the company what he owed, the top copy, I suppose, would be torn out and handed as a receipt to the customer who had paid, and the duplicate would be turned down again and would then become the record, the admission by the salesman of the fact that he was accountable for the money shown on that turned-down invoice.

Now the effect of that system was this, that there never would be recorded in the daily sales cash book in regular order, or in consecutive order, these invoices. They would be entered in the daily sales cash book, in what one may call a disorderly manner, that is to say, the numbers would not follow one another consecutively. On the first day of the week it might well be that there would be half a dozen transactions for ready cash, and perhaps two on short credit. On the second day of the week, when the duty of the manager was to enter these invoices in the daily sales cash book, he would only enter those in respect of which cash had been received, and for which he was then accountable, and the other invoices made out in respect of credit transactions would not be entered in the cash book until the cash had actually been paid to the sales manager, which might be some days later; and so the whole order of entering these invoices in the daily sales cash book would in that way be disarranged.

Now the evidence, to my mind, is clear that that system of using the invoice book for ready-money transactions as well as for short-credit transactions had been going on for years, and it is equally clear to me that that system, and the so-called system of keeping a record of the transactions done on credit by turning up the invoice, was also known to the directors and had been known to them for years.

Now it is quite clear that if you have got a dishonest salesman, and if that is the system, and if you have got directors who do not do their duty—their duty, or the duty of one of them, being the duty imposed by the practice of the company, to see that he got from the salesman the cash for which the salesman was accountable—the salesman can rob, and can rob because he receives cash upon transactions which have been for short credit, does not turn down the invoice which has been a record of such a transaction, and conceals from the person to whom he is accountable the fact that he has received the cash. It is comparatively easy, and that was the way in which this man Spicer was enabled to misappropriate considerable sums of money from the company.

Now, of course, the auditors' duty is, as far as possible and within reasonable limits, to see that the company has received the cash which it ought to have received from sales which have been made. It is necessary that they should do that for the purpose of getting the balance sheet out, or for the purpose of seeing that the balance sheet is correct, because in it there is the profit and loss account, and you have got to verify the trading results; and they did check the cash book with the invoices, but they did not find out that on some of the invoices that had been turned up and were represented to be still outstanding credit transactions, Spicer had in fact received and pocketed the money.

Now what is charged against them first of all is that they omitted to provide an efficient system of verifying the cash received by Spicer in respect of sales from the company's showroom, and what was said by Mr. Coen, and said, I think, with considerable force, was that all this trouble arising from the turning-down

of the invoices might have been got rid of if there had been established in the showroom a sundries ledger, for the purpose of—to use the expression which I think is used by those who are in the habit of dealing with accounts—‘taking care’ of these short-term credits. I agree, and I do not think anybody could question but that such a system, the credit transactions being first of all recorded in the day book and from there posted to a sundries ledger, would be infinitely preferable to the system which was countenanced in this business, about which I have no doubt the directors knew.

Now, the first charge is that they ought to have insisted upon some such system. Well, it is clear that Mr. Beeby did want an alteration in the system which was employed. He did not want it altered in the direction in which Mr. Coen suggested that it might easily have been altered, but what he wanted them to do was to keep a record of these credit transactions in the counting-house, and to that Mr. Seager objected, and he objected because either it was too expensive or it was too cumbersome, or for some reason or another.

Now that shows, to my mind, that the unsatisfactory system employed in regard to these showroom accounts was present to the mind of Mr. Beeby, and it also indicates to me that it was called by him to the attention of the directors, and that notwithstanding that fact they preferred for some reason or another to continue the system as it was. I am not prepared to hold, in those circumstances and on those facts, that there was any duty upon the auditors to insist upon that system being changed. It is not their business to tell the directors how to carry on and conduct their accounting system; they make their recommendations, and if they are not acceded to, the responsibility is not the auditors' responsibility, but it is the responsibility of the directors.

Now the next charge against the respondent is that in doing what they were bound to do, checking the receipt of cash, the auditors ought, by reason of the irregularity of the way in which the invoices were recorded in the daily sales cash book, to have realised that something was wrong. There is no doubt that invoices were entered out of their chronological order, and there is no doubt that little batches of invoices with consecutive numbers were entered in the daily sales cash book after the dates upon which they ought to have been entered. There was that kind of irregularity in the order in which the invoices were entered in the cash book going on throughout the period with which we are concerned, and I have no doubt that if those invoices were to be regarded, and if those invoice books were to be regarded, and if they ought to have been regarded as receipts for sums of money given by the manager of the showroom, the irregularity in the order in which the duplicates were entered in the daily sales cash book was a matter which ought to have put the auditors upon their guard, and done more than put them on their guard, ought to have provoked inquiry. But when the invoices cannot, because of the system, be regarded as receipts; when, because of the system of using the same books for credit transactions as for cash transactions, there must necessarily be disorder in the way in which the invoices are recorded in the daily sales cash book, and when the purpose for which you are checking the invoices with the cash book is merely to see that the company has received from the showroom manager the cash for which the showroom manager is accountable, the order in which the invoices are recorded in the cash book becomes of comparatively small importance, if it has any importance at all. The point is, has the man accounted for the money for which by his invoices he admits that he is accountable? Once you have traced invoices upon which he is accountable into the cash book, there I think the matter ends, so far as the auditor is concerned. That point, which I confess seemed to me when Mr. Coen was opening this case to be a formidable one, I think ceases to have any importance at all when you realise the manner in which this business was, with the assent, or at any rate the knowledge, of the directors, being carried on; and I do not find that in that matter of the irregularity of the entries there was anything which ought to have provoked the auditors to inquiry, or aroused in their minds any suspicion.

Now the next complaint, or the next matter of negligence which is complained of, arises with respect to duplicate entries in the daily sales cash book. It is the fact that there were quite a number of cases in which the same invoice is entered twice in the daily sales cash book, and that means, of course, that the sales-

manager who has to account for the money recorded upon an invoice entered in the cash book is making himself liable twice over for the same sum of money. I think that such a matter, when found, at once demands an explanation; it must do; and it should appear, or it should have appeared to the auditor when he was auditing the accounts in connection with this department, and it did appear.

There are still in existence some of the notes which were made by Mr. Flutter or his assistants, of whom I think he had two or three, upon matters which required explanation at the time when he was auditing the accounts for the four years with which I am concerned, and most of the duplicate entries in the cash book found a place in those notes. Mr. Flutter's evidence was that upon those notes there were matters about which he needed explanation, and upon which he got explanations from somebody, with which explanations he was satisfied. There is only one case of a duplicate entry recorded on his notes with respect to which he can remember what the explanation was, and I am asked to conclude that negligence has been established because, first of all, there were these duplicated entries and no satisfactory explanation of them has been forthcoming in evidence.

Well, if it was not possible for any satisfactory explanation of them to be forthcoming in evidence, I think the applicant would have gone a long way to have proved his case; but it is conceivable that an explanation which would be satisfactory to a reasonable man who was trying to do his duty might have been given. I have got Mr. Flutter's evidence that he did make these inquiries, and that he did receive an explanation, and that the explanation was satisfactory, although he cannot himself remember, after this lapse of time, what the explanation was. I am quite sure that it would have been wrong for me, on this point, after this lapse of time, merely because a man whom I believe to have been trying to do his duty, and whom I believe to be an honest man, cannot remember an explanation which he says was satisfactory to him at the time when he received it—it would not be right, or at least I cannot bring myself to believe that it would be right, when the evidence stands in that way, to infer against this man that he has been guilty of professional negligence. So, in my judgment, the charge in respect of that matter breaks down.

Now, there is another point, a point which was raised this morning by Mr. Coen, who, if I may say so, presented the case for the applicant with great skill and with great care and fairness. It is a point arising upon the failure of Mr. Flutter to obtain from anybody a satisfactory explanation with regard to some of the matters raised on his notes. There were a number of matters raised on Mr. Flutter's notes with regard to which Mr. Coen argued that Mr. Flutter could not possibly have got from anybody a satisfactory explanation. To take an example, in the audit notes for the year 1930, there are recorded as matters upon which Mr. Flutter required explanations five or six unpaid accounts with respect to which it is now admitted, or has been proved, that Spicer had misappropriated the money.

Now, I am not clear about this. I am not clear that some satisfactory explanation may not have been able to have been given by somebody to Mr. Flutter in 1930 with respect to these items. Although it has been established, or admitted, that Spicer misappropriated the money, it has not been established, I think, with respect to the matters inquired into in 1930, that Spicer had misappropriated the money then. It may well be that the misappropriation did not take place until a later date. I do not know. But again, believing as I do that Flutter was an honest man, and believing as I do that he was trying to do his duty, and as the notes show, conducting his inquiry with some degree of care, I am not prepared to hold merely upon the argument of counsel—because that is really what it comes to—that it was not possible for there to be any satisfactory explanation of those matters indicated by Mr. Flutter in his notes as being outstanding at the time when he was making his audit.

I think that really disposes of all the grounds of negligence which have been urged in the course of this case against the respondent. There are some matters which, in the opening, were dealt with as matters upon which the respondent had displayed negligence. One of the matters was in respect of his failure, on some of the invoices, to observe the impression of a receipt stamp. I looked at them, and they are not so clear as might be supposed; and it is quite possible, I think, and in fact I am satisfied that it is quite possible, for a man who has not got his

suspensions aroused to have failed to observe the very faint impression, in some cases, on a duplicate invoice of a receipt stamp put upon the top copy.

There is also a suggestion that he was negligent in failing to notice that discount had been deducted, discount which apparently was put into his pocket by this man Spicer. Well, I do not think there is anything in the duplicate invoice which necessarily would arouse the attention of a careful auditor.

The last matter was with regard to the opening up by the auditors of what were called the reconciliation statements at the foot of the totalling of the daily sales cash book at the times when Spicer was accounting to a director of the company for the cash he had received. It is quite plain that if it had been the duty of the auditor to have opened up those cash reconciliations, the fact that there was something wrong going on would have been obvious, because on a great many of those reconciliation statements will be found the fact that a cheque is being handed over in discharge of Spicer's liability as shown by the book, when no transaction in respect of which that cheque could have been given is recorded in the accounting period, whilst a day or two later there is recorded a transaction in respect of which the cheque must have been given. I have not the smallest doubt but that if the auditor's duty had been to open up those reconciliation statements, and if he had done his duty, he could not have failed to discover that there was something wrong.

But with regard to those reconciliation statements the evidence of the expert witnesses is all one way, including those called on behalf of the applicant, that there is no duty upon an auditor checking a cash book to open up those reconciliation statements until the time arrives when his suspicion has been aroused, and then, of course, everything at once has to be opened up and looked into. So that that matter really does not appear to me to be one upon which a charge can be made against the auditor as a matter of negligence.

I think I have now disposed of all the points which have been raised. I have no doubt as to where the primary responsibility for finding out the defalcation of this man Spicer lies. It lies upon the shoulders of the man whose duty it was, as a director of this company, to collect from Spicer the cash that he received. If that man had done his duty in any degree at all, the frauds could not have been perpetrated in the way in which they were perpetrated. Whether they could have been perpetrated in another way, I do not know, but they would not have been perpetrated in the way in which they were perpetrated; and it is those people who have failed to discharge the duty that they owed to the company, and not the auditors.

Upon the whole matter, having considered everything as best I can, on the notes of the audit, the way in which Mr. Flutter gave his evidence, and the way in which the accounts of this company were kept, I am satisfied that Mr. Flutter was an honest man, trying to do his duty, and the applicant has quite failed to satisfy me, in respect of the matters charged, that there was any negligence. The result is that the application fails, and must be dismissed. I understand that the company is a solvent company, and I suppose the order will be that the costs of the respondent be taxed and paid by the applicant out of the assets of the company in his hands as liquidator. I suppose there are assets, Mr. Coen?

Mr. Coen: Yes, my lord, there are assets.

Mr. Justice Bennett: Very well, then that is right. The order should be against the liquidator personally, with liberty to him to recoup himself out of the assets of the company.

Mr. Philip Vos: I ask your lordship not to limit the order in that way, but to follow the precedent which your lordship set up in the case of the *Westminster Road Construction Co.* (76 *The Accountant* L.R. 38).

Mr. Justice Bennett: I order that the applicant pays the respondent's costs, but that he may take those costs out of the assets. That is the proper order.

Mr. Philip Vos: If your lordship pleases.

Mr. Coen: In view of that order, I do not know whether it is necessary for me to ask this, but it is a matter of some importance to the applicant: Is your lordship prepared to say that this was an application which was proper to be brought by the liquidator?

Mr. Justice Bennett: Oh, yes; I think there was matter which required to be

investigated. Nobody could suggest that there was not. What is the point of that? He will get his own costs out of the assets.

Mr. Coen: That is the only point, my lord.

Mr. Justice Bennett: Oh, yes. I do not for a moment suggest otherwise.

Mr. Coen: If your lordship pleases.

REX v. HINDS, MUSGRAVE AND STEVEN

(Trial at the Old Bailey, July-August, 1950, before Mr. Justice HUMPHRIES and a jury.)

The following appeared in 'The Accountant', 12th August 1950

In December, 1947, Richard Crittall & Co. Ltd., an engineering concern, issued a prospectus, in which the public were invited to apply for 450,000 £1 preference shares. The issue was over-subscribed, but during 1948 a receiver was appointed and, subsequently, the Board of Trade appointed an inspector under Section 165 of the Companies Act, 1948, to investigate the affairs of the company. A little over a week ago, a prosecution in connection with the prospectus ended, after a fifteen-day trial, with the conviction of two directors and the acquittal of the auditor, Kenneth Forbes Steven.

The prosecution was brought under Section 12 (1) of the Prevention of Fraud (Investments) Act, 1939.

Two matters formed the basis of the prosecutions in the *Crittall* case. Firstly, there was a 'forecast' that the profits for 1947 would be not less than £100,000 and, subject to certain provisos, that for 1948 they would be not less than £150,000. The Crown's case was that, far from there being reasonable grounds for this estimate, the indications up to the time when the prospectus was issued, which was as late as December, 1947, were that the company was trading at a loss. Musgrave, the chairman and joint managing director, who was a technician and had relied on others for his information, was charged with and found guilty of inducing three persons to apply for shares by making a misleading forecast recklessly. It was alleged, and found, that Hinds had made the misleading forecast knowingly. These forecasts were, of course, not contained in the auditor's report and Steven was not concerned with these particular counts.

The other counts related to a sum of £99,746, which was shown under 'current assets' as 'expenditure in connection with development and expansion of export trade and newly-formed subsidiary and associated companies—carried forward'.

It was alleged that this, together with the profit figure for 1946, when the expenditure was incurred, was a misleading 'statement', and that all three accused were guilty of making it recklessly. The evidence was extensive and during the trial a great deal of information was disclosed of which neither Musgrave nor Steven was aware at the material times. Hinds was convicted on this charge and Musgrave and Steven were acquitted.

The few sentences which a press reporter culls from a day's proceedings in the Courts necessarily convey very little, and it is therefore proposed, in fairness to Mr. Steven and his firm, Singleton, Fabian & Co., to publish longer extracts from Mr. Justice Humphrey's summing-up than have hitherto appeared. In dealing with the charge against Mr. Steven, the learned judge said:

'When the case for the prosecution was concluded, his counsel submitted to me that there was no case to go to you at all against Mr. Steven, and I decided against him. I decided against him . . . upon this ground . . . he was a person in a responsible position and I thought, assuming of course (it is for you to find) you were satisfied that it was a misleading statement, he was responsible for it in the sense that he put it forward, and I thought, therefore, that it was for him to explain to your satisfaction how he came to do that. And he has explained it.

' . . . It appeared that Mr. Steven had not accepted anything he was told by anybody, but he had in fact made the most intimate inquiry into various things. . . . I do not think I can help you by going into the various examinations that he made. It is proved that he did, in various ways, examine the accounts and it is agreed that all his examinations turned out to show that the accounts were correct with the exception of this particular item of £99,000.

Now, he did not know where that came from but at that time he asked Mr. Morton [a partner] to investigate that matter and, of course, one realises that a man in the position of an auditor is probably an extremely busy man, like a solicitor. It is not the only piece of business that he has got to attend to and he must have an assistant to take part of the burden off his shoulders. He should not take from his assistants everything they say, perhaps, but to a great extent he must rely upon his assistants. In this case he relied upon someone who was more than an assistant; he was a partner.'

The learned judge went on to summarise the tests which Mr. Morton made, and added:

'it seems to me a very serious matter for your consideration whether you can possibly say that Mr. Steven, having handed that matter over to his partner, and his partner having in fact made tests and satisfied himself, rightly or wrongly—as we now know, wrongly—but satisfied himself at the time as an honourable man, as an accountant, and a careful accountant, that that document was right—can you say that Mr. Steven was reckless in accepting Mr. Morton's explanation of that?—because, as I see it, the whole of this case now depends, so far as he is concerned, almost entirely on that document Exhibit 23 [which related to the allocation of the sums carried forward amongst various subsidiaries]. That is the one thing that is said to be against him. There is plenty of evidence that in the other parts he took meticulous care in trying to ascertain whether the books of this company were reliable or whether they were not. But in this particular his evidence is: "I relied upon Mr. Morton".'*

Mr. T. B. Robson, F.C.A., appeared as a witness for the defence, and his evidence was corroborated by Sir Harold Barton, F.C.A. It is perhaps significant that there was no cross-examination of these witnesses.

We conclude with two more extracts from the summing-up which are of more general interest.

'I think it right to say this (although it will not affect, and is not intended to affect your verdict) that it does call for consideration by the authorities whether this system of appointing a firm of auditors is a satisfactory one. . . . It may be that this case has shown that it is not very satisfactory, because you do not get what everybody desires—the personal assurance of an individual who is an expert that this is right. It turns out that all you get is, instead of a personal assurance, that that expert, it may be, accepted somebody else's view. It is very difficult to fix responsibility in that case. That is another matter. But in this case what he did was perfectly right and proper.'

The following passage deals with the duties of an auditor with regard to the prospectus:

'And nobody, least of all Mr. Roberts, appearing on behalf of the defendant Steven, has attempted to minimise the importance of an auditor who is responsible for a very, very important part of any prospectus inviting the public to subscribe, the importance of his exercising great care in every word that he puts in his report, and in particular, of course—because that is his peculiar province—to see that the accounts are correct, so far as he can possibly ascertain, and that any important item is fully explained. You will remember what Mr. Burleigh [the inspector appointed by the Board of Trade] said in this case. He is not an auditor, although I expect he has done that work many times; he was speaking as an accountant. He said the great, important thing to aim at in accountancy—it is not a hocus-pocus sort of business done in the dark—the great, important thing is to let people know exactly what you are doing, and that you must leave it to them to judge what they will do finally. Let them understand the figures which you are putting before them.'

* The above extract was quoted in a letter from the Secretary of the Institute of Chartered Accountants in England and Wales to the editor of the *Financial Times*, published on 5th August, 1950. The letter also quoted the following further extract from the summing up: 'In this case there is the sworn evidence of Mr. Morton, who of course was not challenged upon this matter, that he did himself make enquiries which satisfied him. What Mr. Steven had done was to find out that his partner had made tests and that his partner was satisfied with that document'. The letter concluded with the observation: 'It would be most unfortunate if, as a result of the abbreviated Press reports, the inference were to be drawn that Mr. Steven's acquittal was achieved merely on a legal technicality arising out of his reliance on his partner.'

APPENDIX C

RECOMMENDATIONS ON ACCOUNTING PRINCIPLES

Issued by

The Institute of Chartered Accountants in England and Wales

I. TAX RESERVE CERTIFICATES

It is considered that regard should be had to the relevant conditions of issue set forth in the leaflet issued by the Treasury on 22nd December, 1941, namely:

- (a) Certificates can be used for the payment of income-tax (except under Schedule E), sur-tax, national defence contribution, excess profits tax, and war damage contributions under Part I of the 1941 Act; but this right is limited to such liabilities falling due not less than two months and not more than two years from the date of the certificate; if so used interest is allowed at 1 per cent. per annum free of tax.
- (b) They are not transferable (except under the ordinary law on death, bankruptcy, &c.), and consequently cannot be pledged as security.
- (c) They may be surrendered after two months against a cash payment but no interest is then allowable.
- (d) The appropriation of the amount represented by the certificate for any of the liabilities referred to in (a) above or the surrender against a cash payment is at the option of the holder.

RECOMMENDATION

It is therefore recommended that:

- (1) The amount of tax reserve certificates held should be shown as a separate item in the balance sheet and grouped with the current assets.
- (2) The 1 per cent. per annum allowed on the surrender of the certificates in payment of taxation, &c., should be treated as interest and not as a reduction of the taxation charge.

Note.—It is suggested that accrued interest to the date of the balance sheet should not be taken to credit unless the certificates have been surrendered before the balance sheet has been signed. (12th December, 1942.)

II. WAR DAMAGE CONTRIBUTIONS, PREMIUMS AND CLAIMS

War damage contributions

- (a) The War Damage Act, 1941, enacts that contributions under Part I (Properties) shall be treated for all purposes as outgoings of a capital nature.
- (b) The liability under Part I is referred to as 'the contribution' and is payable by five annual instalments, the first of which was due on 1st July, 1941. The risk period under the Act of 1941 covered by this contribution extended from 3rd September, 1939, to 31st August, 1941.
- (c) Under the War Damage (Amendment) Act, 1942, the risk period covered by the contribution was extended for all purposes to 31st August, 1942, and thereafter until terminated by an order made by the Treasury and approved by a resolution of the House of Commons.
- (d) It has been the general practice on the ground of financial prudence to make provision for the full contribution out of available profits or free reserves.

RECOMMENDATION

Bearing in mind that (i) payment of the contribution adds nothing to the asset values, and (ii) notwithstanding (a) above, it is open to directors to achieve the same result by appropriating profits to a reserve equivalent in amount to the contribution if treated as capital, the general practice referred to in (d) above is recommended. But whatever course is adopted the annual accounts should show the facts in order that they may be before the shareholders when approving the accounts.

In cases where the full contribution for the cover has been provided to 31st August, 1942, no provision is considered to be necessary in respect of possible contributions for subsequent periods.

War damage premiums

The War Damage Act, 1941, enacts that premiums under Part II (plant, equipment, &c.) shall similarly be treated as outgoings of a capital nature.

RECOMMENDATION

For the same reasons as in the case of Part I and particularly as premiums under Part II cover a risk for a definite period under the terms of a policy, it is recommended that, in whatever manner the contribution under Part I may have been treated, the premiums under Part II should be provided out of available profits or free reserves by reference to the period covered.

Note.—The recommendations made, above regarding contributions and premiums may not be appropriate to certain classes of companies, such as statutory companies, property companies and building societies or where property is held for sale.

War damage claims—fixed assets

The treatment in published accounts of war damage claims on fixed assets is already fully covered by a circular letter issued to professional firms on behalf of the Council by the Secretary of the Institute dated 20th August, 1941. It has, however, transpired that many industrial accountants are not aware of the Council's recommendations in this connection and accordingly it is considered desirable to include the following extracts from the letter referred to.

'The Ministry of Information have in a considerable number of cases approved the use of the following alternative forms of wording which have been agreed with groups of accountants, as a note on balance sheets of companies whose assets have suffered war damage, with a view to the avoidance of qualifications in the auditor's report:

- (a) Owing to the war, adjustments will be required at a future date in respect of certain of the assets included in the above account.
- (b) Adjustments are required to certain assets which will be dealt with when the position is fully ascertained.

'The Council have had these suggested wordings under consideration, and I am instructed to advise you that whilst in many cases the forms of wording might be appropriate, the Council feel that standard forms of qualifications tend to become restrictive and might not be appropriate in all cases. Every case must be considered on its merits, including the question as to whether the company is a subsidiary where a qualification in an auditors' report might possibly be unavoidable.

'It is understood that the Ministry of Information has no desire to standardise any particular form or forms of words. Its sole concern is to advise whether the accounts as presented contain information which might be useful to the enemy. Every case in which accounts are submitted to the Ministry will be considered with a view to allowing the maximum information compatible with safety to be published. In general, the extent to which particulars of damage can be stated will depend largely on the importance of the particular company to the country's war effort.'

(12th December, 1942.)

III. THE TREATMENT OF TAXATION IN ACCOUNTS

(See also, on page 871, amendment issued in May, 1948.)

The incidence of taxation and its effect on profits and on the financial position disclosed by the balance sheet, together with the extent to which the Inland Revenue on the one hand and shareholders on the other have participated in profits, are matters which should be made clear to shareholders.

The assessment of liability to national defence contribution and excess profits tax is based on the profits of the accounting period under review. The assessment of liability to income-tax is, however, for the fiscal year ending 5th April and is normally based on the profits of a preceding accounting period. The minimum or legal amount to be provided for taxation is thus the aggregate of taxes assessable on these bases, apportioned, as regards income-tax, according to the period covered by the accounts under review.

Income-tax so apportioned takes no account, however, either of the balance of the liability assessable for the current fiscal year, or of the liability which, in normal circumstances, will arise in respect of profits included in the accounts but

not assessable until the following fiscal year. Further, unless provision be made year by year for income-tax based on each year's results, the trend of net available profits will not be apparent, and cases will arise where the profits earned in a succeeding period will bear a disproportionate charge for taxation—indeed, they may even be insufficient to meet it.

In the case of principal and subsidiary companies (as defined in the Finance (No. 2) Act, 1939) excess profits tax is assessable on the principal company in respect of the net excess profits of the group. The principal company has, however, the option of recovering from any subsidiary the tax charge relative to the excess profits of such subsidiary or of crediting any subsidiary with the tax benefit arising from the deficiencies of such subsidiary. The charge for taxation in the principal company's accounts thus depends upon the exercise (in whole or in part) of the option to allocate excess profits tax over subsidiaries and may not be appropriate to the profits shown in the principal company's own accounts.

RECOMMENDATION

It is therefore recommended that:

(1) The charge for income-tax should be stated in the accounts, and, subject to war-time or other special circumstances, the charge for national defence contribution or excess profits tax should also be stated.

(2) —

(a) The charge for income-tax should be based on the profits earned during the period covered by the accounts.

(b) Where it has been the practice to charge only the minimum or legal liability, then, until full provision has been made for income-tax on all profits up to the date of the balance sheet, it is desirable where possible to make provision, in addition, for or towards the balance of the liability for the current and following fiscal years. This provision should be shown separately in the profit and loss account.

(c) Whatever method is adopted, the bases (i) of the charge and (ii) of any supplemental provision made for income-tax should be disclosed.

(d) Income-tax on revenue taxed before receipt should be included as part of the taxation charge for the year and the relative income should be brought to credit gross.

(3) In the case of principal companies it should be indicated whether the provision for excess profits tax is in respect of the group or whether the sum charged has been arrived at after taking into account amounts allocated over subsidiary companies.

(4) Taxation charges may be affected by losses in the current period, deficiencies brought forward or adjustments of taxation in respect of previous periods, the effect of which, if material, should be disclosed. Any provision made in excess of the amount required to cover the estimated future liability on profits earned to date should, if material, be similarly disclosed.

(5) Any provision for (or in excess of) the estimated future liability to income-tax in respect of the fiscal year commencing after the date of the balance sheet should not be included with current liabilities but should be grouped with reserves or separately stated as a deferred liability and suitably described.

(13th March, 1943.)

IV. THE TREATMENT IN ACCOUNTS OF INCOME TAX DEDUCTIBLE FROM DIVIDENDS PAYABLE AND ANNUAL CHARGES

The payment of a dividend to shareholders does not affect the amount of tax payable by a company, the assessment being on the amount of the profits as adjusted for the purposes of income-tax.

On the other hand, income-tax deducted upon payment of debenture and other interest, royalties and similar annual charges is in effect assessed on a company for collection from the payee.

RECOMMENDATION

It is therefore recommended that:

(1) —

(a) Whether dividends are described 'less income-tax' or 'free of income-tax' the amounts shown in respect thereof in the accounts should be the net amounts payable.

- (b) Where a company continues the practice of providing for dividends gross the narrative should indicate that the distributions are subject to income-tax. The taxation charge should be arrived at after taking credit for the tax deductible on payment of the proposed dividends.
- (2) Annual charges for debenture and other interest, royalties and similar annual payments should be charged gross. (13th March, 1943.)

V. THE INCLUSION IN ACCOUNTS OF PROPOSED PROFIT APPROPRIATIONS

Although certain appropriations of profits, including dividends recommended by directors are subject to subsequent confirmation by shareholders, the inclusion of all appropriations in the accounts shows the amount which will be required for distribution to the shareholders and completes the accounts for the financial year by showing the results of trading and their application in one account. This course avoids the inclusion in the accounts of the next period of appropriations which were set out in the directors' report for the previous period, and have already been dealt with and disposed of. Also, it facilitates the linking up of the accounts from one period to another, the balance carried forward to the following period being clearly shown in the accounts of each year.

RECOMMENDATION

It is therefore recommended that:

Provision be made in the books and in the annual accounts for proposed profit appropriations, those subject to confirmation by shareholders being so described. Provision for dividends should be shown as a separate item in the balance sheet.

(13th March, 1943.)

VI. RESERVES AND PROVISIONS

(See also, on page 871, amendment issued in May, 1948.)

A true appreciation of the financial position of a company as disclosed by its balance sheet may be rendered difficult or even impossible owing to lack of information as to the extent of undisclosed reserves and to insufficient distinction being made between (a) free reserves retained to strengthen the financial position or to meet unknown contingencies; (b) capital reserves or other reserves not normally regarded as available for distribution as dividend; (c) provisions for known contingencies; and (d) provisions for diminution in value of assets in excess of normal or estimated requirements.

The terms 'reserves' and 'provisions' are commonly regarded as interchangeable. Accounts would be more clearly understood if the term 'reserve' were applied only to reserves which are free, and the term 'provision' were confined to amounts set aside for specific requirements.

Unless the amounts involved are stated, the trend of profits may be obscured by transferring amounts to or from undisclosed accounts of the nature of free reserves, by charging abnormal provisions or by utilising provisions no longer required.

RECOMMENDATION

It is therefore recommended that:

(1) The following distinction should be made between reserves which are free and those in the nature of provisions for specific requirements; the latter should preferably be described as 'provisions':

- (a) The term 'reserve' should be used to denote amounts set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist as at the date of the balance sheet.
- (b) The term 'provision' should be used to denote amounts set aside out of profits or other surpluses to meet:
 - (i) specific requirements the amounts whereof can be estimated closely; and
 - (ii) specific commitments, known contingencies and diminutions in values of assets existing as at the date of the balance sheet where the amounts involved cannot be determined with substantial accuracy.

(2) Reserves, as defined in (1) (a) above, should be disclosed in the balance sheet. The term 'reserve fund' should only be used where a reserve is specifically represented by readily realisable and earmarked assets.

Where two or more reserves are retentions of distributable profits available for general use in the business and none of them is created in accordance with statutory requirements or in pursuance of any obligation or policy, the subdivision of such reserves under a variety of headings is unnecessary. Capital and other reserves not normally regarded as available for distribution as dividend, should, however, be separated from those of a revenue nature, the latter group to include any undistributed balance, or, by deduction, any adverse balance on profit and loss account.

(3) As a general principle 'provisions' as defined under (1) (b) (ii), should be disclosed in the balance sheet under one or more appropriate headings. Only in circumstances where disclosure of the amount of a particular provision would clearly be detrimental to the interests of a company should it be included under another heading, for example, 'creditors'; the fact that such heading includes 'provisions' should then be indicated in the narrative.

Where practicable, fixed assets in existence at the date of the balance sheet should be shown at cost, and provisions for depreciation and for diminution in values should appear as separate deductions therefrom.

(4) Subject as in (3) above in regard to provisions the disclosure of which would be detrimental to the interests of a company, where reserves and provisions are created or increased, the amounts involved, if material, and the sources from which they have been created or increased, should be disclosed in the accounts. In all cases the utilisation of reserves, and of provisions proved to have been redundant, should be disclosed in the accounts.

(23rd October, 1943.)

VII. DISCLOSURE OF THE FINANCIAL POSITION AND RESULTS OF SUBSIDIARY COMPANIES IN THE ACCOUNTS OF HOLDING COMPANIES

Where a company holds a direct or indirect controlling interest in another company or companies (referred to in this memorandum as 'subsidiary undertakings'), a true appreciation of the financial position and the trend of results of the group as a whole can be made only if the accounts of the holding company as a separate legal entity take into account or are supplemented by information as to the financial position and results of the subsidiary undertakings. The following are three methods of disclosing this supplemental information. Each has its own value and limitations. The first and second methods are suitable only in special cases.

Method (1): To submit copies of the accounts of each of the subsidiary undertakings.

This method is suitable only where it is desired to focus attention on the financial position and earnings of each component of the group. It is impracticable where the companies are numerous and, in all but the simplest cases, the shareholders of the holding company could not obtain a true view of the group as a whole without considerable explanation of inter-company relations.

Method (2): To submit statements of the consolidated assets and liabilities and of the aggregate earnings of the subsidiary undertakings as distinct from those of the holding company.

This method is of value where it is desired to show the underlying assets which represent the investment of the holding company in its subsidiary undertakings, or particular groups of them, and also the earnings attributable thereto.

Note.—As regards methods (1) and (2), if the holding company trades extensively with or through its subsidiary undertakings, the disclosed earnings of the subsidiary undertakings may not by themselves be a true criterion of the real value of the holding company's interests in such undertakings; in such circumstances their value cannot be assessed separately from the value of the group undertaking as a whole.

Method (3): To submit a consolidated balance sheet and a consolidated profit

and loss account of the holding company and of its subsidiary undertakings treated as one group.

This method is the most suitable for general application.

It must, however, be remembered that a consolidated balance sheet is not a record of the assets and liabilities of a legal entity and that the liabilities of each company in the group are payable only out of its own assets and not out of the combined assets of the group. Also, there may be special cases where it may be impracticable or inappropriate to include the figures of a particular subsidiary undertaking in the consolidation. This applies especially in the case of subsidiary undertakings operating overseas where, apart from the temporary difficulty of enemy occupation, there may be restrictions on exchange.

A consolidated profit and loss account does not suffer to the same extent from these limitations and, subject to any necessary explanations, the aggregate results of the group as a whole can be stated. Such disclosure is important even if for any reason the publication of a complete consolidated balance sheet is impracticable or inappropriate.

RECOMMENDATION

It is therefore recommended that in the case of every holding company: *

(1) With the published accounts, statements should be submitted in the form of a consolidated balance sheet and consolidated profit and loss account or in such other form as will enable the shareholders to obtain a clear view of the financial position and earnings of the group as a whole.

(2) Every consolidated statement should indicate:

(a) The nature and measure of control adopted as a basis for the inclusion of subsidiary undertakings.

(b) The reasons for the non-inclusion of any subsidiary undertakings which would normally be included on the basis adopted for the group.

(c) The procedure adopted in cases where the accounts of subsidiary undertakings are not made up to the same date as the accounts of the holding company.

(d) In the case of subsidiary companies operating overseas, if relatively important, the basis taken for the conversion of foreign currencies as affecting assets, liabilities and earnings.

(3) The consolidated balance sheet should exclude inter-company items and should show the combined resources of the group and its liabilities and assets, aggregated under suitable headings. It should distinguish between capital reserves not normally regarded as available for distribution and revenue reserves, including those which would be available for distribution as dividend by the holding company if brought into its accounts. It should also show the interests of outside shareholders in the capital and reserves of the subsidiary undertakings and, under a separate heading, the interests of the group in subsidiary undertakings which have not been consolidated.

(4) The consolidated profit and loss account, or other information given as to the earnings of the group, should disclose the aggregate results of the group for the period covered by the accounts, after eliminating the effect of inter-company transactions. It should be in such a form that these aggregate results may readily be reconciled with those shown by the profit and loss account of the holding company, in which should be stated separately the aggregate amount included in respect of subsidiary undertakings whose accounts have not been consolidated.

The following, *inter alia*, should be separately stated:

(a) The aggregate results of any subsidiary undertakings the balance sheets of which have not been included in the consolidation.

(b) The portion of the aggregate net results attributable to outside shareholders' interests in the subsidiary undertakings.

(c) The portion of the consolidated net results attributable to the holding company's interests which remains in the accounts of consolidated subsidiary undertakings or the amount by which the dividends from such subsidiary undertakings exceed the holding company's share of their earnings for the period.

(5) Profits earned and losses incurred by subsidiary undertakings prior to the acquisition by the holding company of the shares to which they are attributable

should be viewed as being of a capital nature from the standpoint of the holding company. Such pre-acquisition profits (whether received in dividend or not) should therefore not be brought into account as being available for distribution in dividend by the holding company.

(12th February, 1944.)

VIII. FORM OF BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

Businesses are so varied in their nature that there must be flexibility in the manner of presenting accounts and a standard form to suit every commercial and industrial undertaking is neither practicable nor desirable. The financial position can, however, be more readily appreciated if the various items in the balance sheet are grouped under appropriate headings and a proper view of the trend of the results can be obtained only if certain principles are consistently applied and if profits or losses of an exceptional nature or relating to previous periods are stated separately in the profit and loss account. In both cases, appreciation is facilitated if the comparative figures of the previous period are also given.

RECOMMENDATION

It is therefore recommended that, subject to compliance with statutory requirements, the balance sheet and profit and loss account should be presented in conformity with the following general principles:

Balance sheet

(1) The use of general headings for a balance sheet, such as 'liabilities' and 'assets', is inappropriate and unnecessary. The various items, whatever may be their sequence or designation, should, however, be grouped as indicated below under appropriate headings. Additional groups may be necessary in certain cases to show the aggregate liabilities and assets subject to exchange or other restrictions, special funds and other special items, such as deferred revenue expenditure. Where any material part of a company's liabilities or assets is in foreign currency, the basis of conversion to sterling should be disclosed.

Share capital

(2) In addition to the authorised and issued amounts of the various classes of capital and the redemption date of any redeemable preference capital, the terms of redemption should be stated. Particulars of any option on unissued capital should also be given. If dividends on cumulative preference capital are in arrear, the gross amounts of dividends in arrear or the date up to which the dividends have been paid should be stated.

Reserves

(3) The items to be included in this group are amounts set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist as at the date of the balance sheet. Capital and other reserves not normally regarded as available for distribution as dividend should be shown separately from those of a revenue nature, the latter group to include any undistributed balance, or by deduction, any adverse balance on profit and loss account.

(4) A sub-total of share capital and reserves should be given to indicate the members' interest in the company.

Debentures, mortgages and long-term liabilities

(5) In this group should be included debentures, mortgages and other long-term loans or liabilities. Where practicable, the dates and terms of redemption should be stated.

(6) The expression 'long-term' is intended to cover liabilities not due for payment until after the lapse of one year from the date of the balance sheet.

Amounts owing to subsidiary undertakings

(7) In addition to the aggregate amount owing to subsidiary companies, the aggregate amount owing to subsidiary companies should be disclosed. Such aggregate amounts may be shown under long-term liabilities, current liabilities, or as a separate group, according to their nature.

Current liabilities and provisions

(8) The items in this group should be classified to disclose their nature and amount including, *inter alia*, (a) trade liabilities, bills payable and accrued charges; (b) bank loans and overdrafts; (c) other short-term loans; (d) interest accrued on debentures and long-term liabilities; (e) provision for current taxation (see Recommendation No. III); (f) provisions to meet specific commitments or contingencies where the amounts involved cannot be determined with substantial accuracy (see Recommendation No. VI); and (g) provision for proposed dividends.

Commitments for capital expenditure

(9) Where commitments of material amount for capital expenditure exist at the date of the balance sheet, these should be indicated in a suitable note.

Contingent liabilities

(10) Contingencies on guarantees, bills under discount, partly paid shares and similar items, should be dealt with by note.

Fixed assets

(11) In this group should be shown under separate headings fixed assets such as (a) goodwill, patents and trade-marks; (b) freehold land and buildings; (c) leaseholds; (d) plant, machinery and equipment; (e) investments acquired and intended to be retained for trade purposes.

(12) Where practicable, fixed assets in existence at the date of the balance sheet should be shown at cost, and the aggregate of the provisions for depreciation and for diminution in values up to that date should appear as deductions therefrom.

Shares in and amounts owing from subsidiary undertakings

(13) In addition to the aggregate amount of shares in, and the aggregate amount owing from, subsidiary companies, which must be stated separately in accordance with the Companies Act, 1929, the aggregate amount owing from sub-subsidiary companies should also be stated. The aggregate amounts owing from subsidiary and sub-subsidiary companies may be shown under fixed assets, current assets, or as a separate group, according to their nature.

Note.—In the balance sheets of subsidiary and of sub-subsidiary companies the aggregate amount of shares in, and the aggregate amounts owing to and from, the ultimate holding company and its subsidiary undertakings should be stated separately.

Current assets

(14) In this group should be included such assets as are held for realisation in the ordinary course of business. They should be stated separately in appropriate sequence and normally include: (a) stock-in-trade and work in progress; (b) trade and other debtors, prepayments and bills receivable; (c) investments held as part of the liquid resources of the company; (d) tax reserve certificates; (e) bank balances and cash.

Note.—Debts of material amount not due until after the lapse of one year from the date of the balance sheet should be separately grouped and suitably described.

Preliminary and issue expenses, &c.

(15) In this group should be included particulars and amounts of expenditure such as preliminary expenses, issue expenses and discount on capital issues not written off.

Profit and loss account

(16) The profit and loss account should be presented in such a form as to give a clear disclosure of the results of the period and the amount available for appropriation, for which purpose it may conveniently be divided into sections.

(17) Such a disclosure implies substantial uniformity in the accounting principles applied as between successive accounting periods; any change of a material nature, such as a variation in the basis of stock valuation or in the method of providing for depreciation or taxation, should be disclosed if its effect distorts the results. The account should disclose any material respects in which it includes extraneous or non-recurrent items or those of an exceptional

nature, and should also refer to the omission of any item relative to, or the inclusion of any item not relative to, the results of the period.

(18) However much supplemental detail of the trading results may be given, the following items should be stated separately in addition to those required by statute:

(a) Income (gross) from investments in subsidiary undertakings.

Notes.—The treatment of income from subsidiary undertakings will depend on the nature of their relations with the holding company and on whether a consolidated profit and loss account is submitted. Where, for any reason, a consolidated profit and loss account is not submitted, income from subsidiary undertakings should be shown separately unless the trading with the holding company is so interlocked that such separate disclosure might create a misleading impression. If a consolidated profit and loss account is submitted, it should disclose, as a minimum, the items referred to below relative to the group as a whole.

(b) Income (gross) from other investments.

(c) Depreciation and amortisation of fixed assets.

(d) Interest charges (gross) on debentures and long-term liabilities.

(e) Credits or charges in respect of provisions, other than those for specific requirements the amounts whereof can be estimated closely. (See Recommendation No. VI.)

(f) National defence contribution or excess profits tax, showing separately, if material, credits or charges in respect of earlier periods.

(g) Credits or charges, if material in amount, which are abnormal in nature or relate to previous periods.

(h) Income-tax and the basis thereof, showing separately, if material, credits or charges in respect of earlier periods. (See Recommendation No. III.)

(i) Amounts set aside for redemption of share and loan capital.

(j) Reserves made or withdrawn. (See Recommendation No. VI.)

(k) Dividends paid or proposed, showing under a separate heading those which are subject to confirmation by the shareholders.

(l) Balances brought in and carried forward.

Comparative figures

(19) Comparative figures of the previous period (prepared on the same basis as those for the period under review) should be given both in the balance sheet and in the profit and loss account.

Disclosure of information

(20) If directors of a company desire to disclose in their report information which, but for its inclusion in the report, would be required to be disclosed in the accounts, the relative paragraphs in the report should be clearly distinguished from the remainder of the report and specifically referred to in the accounts.

(15th July, 1944.)

IX. DEPRECIATION OF FIXED ASSETS

Fixed assets, whatever be their nature or the type of business in which they are employed, have the fundamental characteristic that they are held with the object of earning revenue and not for the purpose of sale in the ordinary course of business. The amount at which they are shown in the balance sheet does not purport to be their realisable value or their replacement value, but is normally an historical record of their cost less amounts provided in respect of depreciation, amortisation or depletion.

Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned.

The assessment of depreciation involves the consideration of three factors: the cost of the asset, which is known, the probable value realisable on ultimate disposal, which can generally be estimated only within fairly wide limits, and

the length of time during which the asset will be commercially useful to the undertaking. In most cases, this last factor is not susceptible of precise calculation. Provisions for depreciation are therefore in most cases matters of estimation, based upon the available experience and knowledge, rather than of accurate determination. They require adjustment from time to time in the light of changes in experience and knowledge, including prolongation of useful life due to exceptional maintenance expenditure, curtailment due to excessive use, or obsolescence not allowed for in the original estimate of the commercially useful life of the asset.

There are several methods of apportioning depreciation as between the several financial periods which constitute the anticipated useful life of the asset. Those most commonly employed in industrial and commercial concerns in this country are the straight-line method and the reducing balance method.

Subject to any periodic adjustment which may be necessary, the straight-line method (computed by providing each year a fixed proportion of the cost of the asset) spreads the provision equally over the period of anticipated use. It is used almost universally in the United States of America and Canada and to a large extent in this country. Though other methods may be appropriate in the case of some classes of assets, the balance of informed opinion now favours the straight-line method as being the most suitable for general application.

The reducing balance method which spreads the provision by annual instalments of diminishing amount computed by taking a fixed percentage of the book value of the assets as reduced by previous provisions, is also largely used in this country. It involves relatively heavy charges in the earlier years of the life of an asset and relatively light charges in the later years. In order to provide depreciation under this method within any given period, the percentage applied needs to be from two to three times that applied under the straight-line method. This is a fact not generally realised, the consequence being that rates of depreciation fixed on this basis may tend to be inadequate.

A third method, known as the sinking fund method, which endeavours to take account of anticipated income from funds set aside for depreciation purposes, is not used to any great extent in industrial and commercial concerns, though in public utility undertakings, where special considerations arise, it is frequently met. Under this method, fixed annual instalments are provided and set aside, which with compound interest, will accumulate to the cost of the asset by the end of its useful life. Where the amounts set aside are invested outside the business, the validity of the calculations depends upon the realisation of the anticipated net rate of interest, and each change in tax rates or interest yield involves recalculation. Where the amounts are retained as additional working capital, the effect is to make a growing charge in the periodic accounts for depreciation, because the fixed periodic instalment has to be supplemented in each period by an amount equivalent to interest on past provisions. Experience shows that, with the uncertainties inescapable in industrial and commercial enterprises, it is not prudent to place reliance upon the accrual of additional earnings to the extent required.

A fourth method, also not commonly used in industrial and commercial concerns, is the renewals reserve method, under which round sums, not necessarily computed by reference to the useful lives of the assets, and sometimes determined largely by the results of the year's trading, are provided and set aside as general provisions towards meeting the cost of future renewals. This method does not accord with a strict view of depreciation and may distort the annual charges to revenue.

The different natures of asset involve consideration in deciding on the method of depreciation appropriate in each case. Unless the methods adopted are applied consistently the usefulness of periodic accounts for the purpose of comparison of one period with another may be vitiated.

Whatever be the method adopted, the periodical revision of depreciation rates and the ascertainment of the residue of cost which has not been covered by depreciation provisions made up to any given date are greatly facilitated by, and often impracticable without, the maintenance of fixed asset registers showing the cost of each asset, the provisions for depreciation made thereon and the basis on which these have been calculated.

RECOMMENDATION

It is therefore recommended that:

1. Provisions for depreciation, amortisation and depletion of fixed assets should be applied on consistent bases from one period to another. If additional provisions prove to be necessary, they should be stated separately in the profit and loss account. Where practicable, fixed assets in existence at the balance sheet date should normally be shown in the balance sheet at cost and the aggregate of the provisions for depreciation, amortisation and depletion should appear as deductions therefrom (see Recommendation No. VIII). The extent to which these provisions are being kept liquid will then be ascertainable from the balance sheet as a whole.

2. Such provisions should be computed on the basis mentioned below as being appropriate to the particular class of asset concerned:

(a) *Goodwill and freehold land*

Depreciation does not arise through use in the business, except in the case of freehold land acquired for purposes such as are referred to in (d) below. Amounts set aside to provide for diminution in value do not constitute a normal charge against revenue and should be shown separately in the profit and loss account.

(b) *Freehold buildings, plant and machinery, tools and equipment, ships, transport vehicles and similar assets which are subject to depreciation by reason of their employment in the business*

Provision for depreciation should, in general, be computed on the straight-line method. Assets of very short effective life, such as loose tools, jigs and patterns, may, however, frequently be dealt with more satisfactorily by other methods such as revaluation, which in no case should exceed cost.

(c) *Leaseholds, patents and other assets which become exhausted by the effluxion of time*

Provision for amortisation should be made on the straight-line basis, including, in the case of leaseholds, allowance for the estimated cost of dilapidations at the end of the lease or useful life of the asset if shorter. If a leasehold redemption policy is effected with an insurance company, the charge of the annual premiums to profit and loss account provides a satisfactory method of amortisation if supplemented in respect of dilapidations.

(d) *Mines, oil wells, quarries and similar assets of a wasting character which are consumed in the form of basic raw material or where the output is sold as such.*

Provision for depreciation and depletion should be made according to the estimated exhaustion of the asset concerned. In the case of an undertaking formed for the purpose of exploiting this particular class of asset, if the practice is to make no provision this should be made clear in the accounts so that shareholders may realise that dividends are, in part, a return of capital.

3. Where a method different from that recommended has hitherto been followed and it is not considered practicable or desirable to make a change in the case of assets already in use, it is suggested that the methods recommended should be followed in cases of assets subsequently acquired.

4. Details of all fixed assets should be kept (preferably in registers specially maintained) to show the cost of each asset, the provisions made for its depreciation and the basis of the provisions made.

5. Amounts set aside out of profits for obsolescence which cannot be foreseen, or for a possible increase in the cost of replacement are matters of financial prudence. Neither can be estimated with any degree of accuracy. They are in the nature of reserves and should be treated as such in the accounts.

(12th January, 1945.)

X. THE VALUATION OF STOCK-IN-TRADE

No particular basis of valuation is suitable for all types of business but, whatever the basis adopted, it should be applied consistently, and the following considerations should be borne in mind:

(a) Stock-in-trade is a current asset held for realisation. In the balance sheet it is, therefore, usually shown at the lower of cost or market value.

(b) Profit or loss on trading is the difference between the amount for which goods are sold and their cost, including the cost of selling and delivery.

The ultimate profit or loss on unsold goods is dependent upon prices ruling at the date of their disposal, but it is essential that provision should be made to cover anticipated losses.

- (c) Inconsistency in method may have a very material effect on the valuation of a business based on earning capacity though not necessarily of importance in itself at any balance sheet date.

The following interpretations are placed on the terms 'cost' and 'market value':

(a) '*Cost*'

The elements making up cost are (i) the purchase price of goods, stores and, in the case of processed stock, materials used in manufacture; (ii) direct expenditure incurred in bringing stock-in-trade to its existing condition and location; and (iii) indirect or overhead expenditure incidental to the class of stock-in-trade concerned.

Whereas the cost of (i) and (ii) can be ascertained with substantial accuracy, (iii)—indirect or overhead expenditure—can only be a matter of calculation. If (iii) is expressed as a percentage of actual production, the amount added to the stock valuation will fluctuate from one period to another according to the volume produced. To avoid distortion of revenue results, in some cases indirect or overhead expenditure is eliminated as an element of cost when valuing stock-in-trade or, alternatively, only that part which represents fixed annual charges is excluded. In other cases, an amount is included which is based on the normal production of the unit concerned.

The following are bases usually adopted in practice for calculating cost:

(1) '*Unit*' cost

Upon this basis, each article, batch or parcel is valued at its individual cost.

In certain cases, such as bulk stocks, this method is not always capable of application and records, including the allocation of expenses, may become unduly complicated. Further, it may not be practicable to apply the method to partly processed stocks or finished products where the individual units lose their identity.

(2) '*First in, first out*'

This basis assumes that goods sold or consumed were those which had been longest on hand and that the quantity held in stock represents the latest purchases.

It has the effect of valuing unsold stock in a reasonably close relation to replacement price. In certain manufacturing or producing businesses, however, it is difficult to apply accurately through the various stages of manufacture or production.

(3) '*Average*' cost

This basis entails averaging the book value of stock at the commencement of a period with the cost of goods added during the period after deducting consumption at the average price, the periodical rests for calculating the average being as frequent as possible having regard to the nature of the business.

It has the effect of smoothing out distortion of results arising from excessive, and often fortuitous, fluctuations in purchase price and production costs and is particularly suitable to manufacturing businesses where several processes are involved.

The bases referred to above are founded on the principle that 'cost' is an historical fact. In some cases, however, their application is unsuitable or impracticable owing to the nature of the business and stock-in-trade is taken at a cost estimated by one of the following methods:

(4) '*Standard*' cost

This basis entails valuing stock at a predetermined or budgeted cost per unit. It is coming more into use, particularly in manufacturing or processing industries where several operations are involved or where goods are produced on mass-production lines.

(5) '*Adjusted selling price*'

On this basis, an estimated cost is obtained by pricing stock at current selling prices and deducting an amount equivalent to the normal profit margin and the estimated cost of disposal.

Other methods of stock valuation are the 'base stock' method, which retains permanently certain basic stock at a fixed price not exceeding its original cost,

and that known as 'last in, first out' which is based on the principle that profit or loss on trading is the difference between the price at which goods are sold and their replacement cost. There is, however, only limited application of either of these methods in this country.

(b) *'Market value'*

The expression 'market value' is commonly interpreted as either:

- (i) the price at which it is estimated that the stock can be realised either in its existing condition or as incorporated in the product normally sold after allowing for all expenditure to be incurred before disposal; or
- (ii) the cost of replacing the stock at the accounting date.

In considering the merits of these alternative methods, regard must be had to the purpose for which stock-in-trade is held, namely, to sell either in its existing condition or as incorporated in a manufactured product. The fact that at the time of valuation the goods could have been acquired at a sum less than their cost only indicates that the expected profit is less than it might have been had it been possible to acquire them at the accounting date—a possibility which often does not exist in view of the quantity held and of the fact that in many cases purchases have to be made for later delivery; the circumstance has not caused a trading loss but only indicates that the ultimate results under other conditions might have been better.

On the other hand, if at the time of the valuation it is clear that selling prices will not cover cost and expenses yet to be incurred before the goods are disposed of, provision is necessary to meet the anticipated loss.

When estimating the amount of the provision required to cover excess of cost over market value, the method employed may be either (i) to consider each article in stock separately, (ii) to group articles in categories having regard to their similarity or interchangeability or, (iii) to consider the aggregate cost of the total stock-in-trade in relation to its aggregate market value.

RECOMMENDATION

It is therefore recommended that:

(1) The basis of valuation for stock-in-trade should normally be the lower of cost or market value, calculated as in (2) and (3) below.

In certain businesses, such as tea or rubber producing companies and some mining companies, there is a general custom to value stocks of products at the price subsequently realised less only selling costs; if this basis is adopted, the fact should be clearly indicated in the accounts.

In the case of long-term contracts, the value placed on work in progress should have regard to the terms and duration of the contracts. If, after providing for all known contingencies, credit is taken for part of the ultimate profit, this fact should be indicated.

(2) Cost should be calculated on such a basis as will show a fair view of the trend of results of the particular type of business concerned. Indirect or overhead expenditure, if included as part of the cost of partly processed or finished products, should be restricted to such expenditure as has been incurred in bringing the stock-in-trade to its existing condition and location.

Stocks of by-products, the cost of which is unascertainable, should be valued at current selling price (or contracted sale price where applicable) after deducting expenses to be incurred before disposal. The cost of the main product should be reduced accordingly.

(3) Market value should be calculated by reference to the price at which it is estimated that the stock-in-trade can be realised, either in its existing condition or as incorporated in the product normally sold, after allowing for expenditure to be incurred before disposal. In estimating this price, regard should be had to abnormal and obsolete stocks, the trend of the market and the prospects of disposal.

If the value of stock-in-trade is calculated by reference to replacement cost, it should be described in the balance sheet as being 'at the lower of cost or replacement value', but in no case should it exceed market value as described above.

(4) For the purpose of estimating the amount of the provision required to reduce stock-in-trade below cost, it may properly be valued on the basis of the

lower of its aggregate cost or of its aggregate market value. On the other hand, a more prudent and equally proper course is to take each item of stock (or each category group) and value it on the basis of the lower of its own cost or market value.

(5) Where goods have been purchased forward and are not covered by forward sales, provision should be made for the excess, if any, of the purchase price over the market value and should be shown as such in the accounts.

Note.—Where goods have been sold forward and are not covered by stocks and forward purchases, provision should be made for the excess, if any, of the anticipated cost over sales value.

(6) Whatever basis is adopted for ascertaining cost or calculating market value, it should be such as will not distort the view of the real trend of trading results and should be applied consistently regardless of the amount of profits available or losses sustained. Any reduction in stock values which exceeds the provisions embodied in the above recommendations is a reserve and should be shown as such in the accounts.

(15th June, 1945.)

XI. EXCESS PROFITS TAX POST-WAR REFUNDS

Material Provisions of Finance (No. 2) Act, 1945

The undertakings to be given under Section 40 of the Finance (No. 2) Act, 1945, include, amongst others, undertakings that:

- (a) 'the net amount of the refund will be used in developing or re-equipping the trade or business and, until so used, will be so dealt with as to remain available for use, when required, in developing or re-equipping the trade or business'.
- (b) '... any part of the said net amount which is not so used shall not be directly or indirectly distributed by way of dividend or cash bonus or capitalised for the purpose of issuing bonus shares or debentures or releasing any liability for uncalled share capital or applied, whether by way of remuneration, drawings, loans or otherwise, for the benefit of partners, shareholders or proprietors.'

Section 47 authorises the Commissioners, subject to specified conditions, to give credit for the net amount of the refund (after deducting income-tax at the standard rate for 1946-47) against excess profits tax liabilities. Any amount so credited is to

'be deemed to have been paid to the Commissioners and repaid by them and the said undertakings and authorities shall, with the necessary modifications, have effect accordingly.'

Section 42 (3) states:

'It shall be the duty of the advisory panel, in such cases and at such times as they think fit, to inquire how the net amount of any post-war refund has been dealt with, and, if, in the opinion of the panel, any part of the said net amount has, under the last preceding section, become due to the Crown, to report to the Treasury accordingly, and no sum shall be so recoverable unless the panel have so reported in respect thereof.'

Section 50 (4) states:

'Where any expenditure has been incurred, on or after the first day of April, 1945, in developing or re-equipping a trade or business, any sum used in or towards the recouping of that expenditure shall be deemed for the purposes of this Part of this Act to have been used in developing or re-equipping that trade or business and any undertakings given under this Part of this Act shall have effect accordingly.'

Observations thereon

- (a) Prior to the enactment of the Act it was recognised accounting practice in a vast majority of undertakings to ignore post-war refunds on the grounds that the right thereto was nebulous and the relative conditions were unknown. The passing of the Act has changed this situation.
- (b) Official guidance is not at present available as to the meaning and scope of the expression 'developing or re-equipping' used in the sections quoted above, nor as to certain other important matters arising in connection with the regulations. The recommendations which are set out below may,

therefore, need modification in the light of experience. It is, however, considered that, in view of the importance of this matter to a great variety of businesses, the Council should indicate now, rather than await the results of experience, the provisional views which it has formed as to the appropriate accountancy treatment of certain aspects of the refund. The notes set out below are designed to deal with the case of the single trading company and no endeavour has been made to comment upon the circumstances peculiar to partnerships, individual traders and groups of companies, the case of assignees of the refunds, and other special cases.

- (c) Special attention is drawn to the stipulation that the refund shall be so dealt with as to remain available for use for the particular purposes specified in the Act. It is to be noted that inasmuch as credits which are set off against liabilities under Section 47 are to be deemed to have been received from the Commissioners, the same obligation rests upon the taxpayer in this connection as if he has actually received these refunds in cash.
- (d) As the net refund must be so dealt with as to remain available for the specified purposes, it may be thought that the only appropriate way of doing this is to open a separate bank account into which the refund would be paid and from which the only permissible payments would be those for the purchase of specific investments for account of the refund and those clearly identified as falling within the scope of the section.

Whilst this procedure would have great merit in a large number of cases in assisting those responsible to demonstrate that the moneys are kept available until used for purposes covered by the section, it is thought that, had Parliament intended such a course to be followed in every case, it would have included a specific provision to that effect in the Act, and would also have included provisions for the payment into such an account of amounts equivalent to the sums deemed to have been received though actually applied in reduction of liabilities. Where an undertaking has ample liquid resources it can readily keep available for use when required an amount equal to the refund; in such a case there seems no reason why, as long as this is done, the refund should not be merged in the general financial resources of the business.

RECOMMENDATIONS

It is recommended that:

(1) Where the amounts involved are material it should no longer be regarded as good accounting practice to ignore the right of a business to post-war refunds of excess profits tax.

(2) If, at the time of the completion of the accounts, the amount of the refund recoverable is not known with substantial accuracy and no amount has been received or deemed to be received on account thereof, no credit should be taken for the refund in the accounts. If, however, the estimated amount of the total refund is material, a suitable note should be made on the balance sheet, giving such indication as may be practicable of the magnitude of the sum involved.

(3) Where, before the completion of the accounts, the amount of the refund has been ascertained either for the whole period or up to a particular date, or a repayment has been received or deemed to have been received, the amount ascertained, received or deemed to have been received, as the case may be, should be credited to a specific reserve or suspense account shown separately in the balance sheet under an appropriate name, such as 'excess profits tax post-war refund suspense account'. Except in cases where the credit represents substantially the whole of the anticipated refund in respect of tax liabilities to the date of the balance sheet, the narrative used should indicate the basis of calculation used and, as far as practicable, should indicate the further net sums which are expected to be received but have not been taken up in the accounts. Alternatively, an appropriate note on the balance sheet should explain the position.

As an alternative procedure where no money has been received or deemed to have been received, an appropriate note mentioning the sum concerned and the basis of its calculation should be entered on the balance sheet.

(4) Where, before the completion of the accounts, the amount of the refund has been ascertained either for the whole period or up to a particular date and is

credited in the accounts as explained above, any part of the refund which has not been received or deemed to have been received in cash should, if material in relation to the other assets, be shown separately as an asset in the balance sheet under an appropriate description such as 'amount recoverable in respect of excess profits tax post-war refund'.

(5) The question whether such an asset, or the cash representing it when received or deemed to be received, should be treated as a current asset or otherwise should be determined according to the facts of the case. The circumstances of business differ greatly. At the one extreme is the business whose refund is clearly a current asset in that it is wholly required to discharge current liabilities existing at the date of the balance sheet for expenditures on developing or re-equipping, or to replace funds already used for that purpose. At the other, is the business whose liabilities do not include any liability for developing or re-equipping and whose refund consequently is not available to meet any liabilities outstanding at the date of the balance sheet or to refund expenditures incurred since 1st April, 1945; in some cases there may, indeed, be little prospects of using the refunds to any substantial extent for several years. In such a case the assets representing the refund, if material, would be better separated from the current assets and grouped under some separate heading in the balance sheet. Between these extremes is a diversity of cases which would seem to call for treatment according to their circumstances, the important point being not to mis-state the net current asset position of the business.

(6) The question whether cash received or deemed to be received in respect of the refund should be paid into a special bank account or merged in the other financial resources should be decided by reference to whether a separate account is necessary in order to keep the appropriate amount available for the purposes for which the refund is intended to be used. Where there is any shortage of liquid resources it may be especially desirable to use such an account so as to obviate the danger of infringing the undertakings to keep the refund available for the prescribed purposes.

(7) A detailed record should be kept of all expenditures which are claimed to represent applications of the refund. This should be kept available so as to show what these are and how they have been treated in the books of the business, in the event of the uses to which the refund is put being challenged at any time by the advisory panel.

(8) For the time being the specific reserve or suspense account arising from the refund, should only be charged with repayments to the Commissioners (including constructive repayments arising because of the occurrence of excess profits tax deficiencies after the periods to which the refund relates) and expenditure on developing or re-equipping which, if the refund were not available for the purpose, would be written off to profit and loss account.

The extent to which the balance on the specific reserve or suspense account has been applied for the prescribed purposes should be indicated in the balance sheet by the insertion of appropriate words in the narrative relative to the balances or in a note thereon.

This recommendation may need further consideration when official guidance is available as to (i) the meaning of the expression 'developing or re-equipping'; (ii) the intentions of Parliament with respect to the period within which moneys must be utilised or repaid to the Commissioners; and (iii) the intentions as to the ultimate destination of balances on the specific reserve or suspense accounts arising from the refund.

(9) Expenditure on the acquisition of capital and other assets should be dealt with in accordance with the normal accountancy procedure and should not be charged against the reserve or suspense account. Depreciation and amortisation therefor should also be charged against profit and loss account in accordance with the normal accountancy practice of the business. (19th July, 1946.)

ADDENDUM

(Note.—An announcement to the following effect was published by the Council in 'The Accountant', 14th December, 1946.)

The attention of members of the Institute is drawn to the announcement dated 8th November, 1946, by the Excess Profits Tax Refunds Advisory Panel.

The recommendations of the Council on excess profits tax post-war refunds should be read with and regarded as subject to the Advisory Panel's announcement, in particular with respect to the modification which is necessary as to the treatment of expenditure on developing or re-equipping which, if the refund were not available for the purpose, would be written off to profit and loss account (see page 868, Recommendations (8)).

ANNOUNCEMENT, 8TH NOVEMBER, 1946

by the

EXCESS PROFITS TAX REFUNDS ADVISORY PANEL

(1) The Excess Profits Tax Refunds Advisory Panel appointed by the Treasury under Section 42 of the Finance (No. 2) Act, 1945, makes the following announcement as to the principles to which it will work in carrying out the duties laid upon it by the Act.

Terms of making over

(2) Where the refund is to be made over to a person or company other than the person or company to whom a refund is due, the Panel is called upon to approve the terms under which it is made over before payment can be made. (The undertakings, &c., do not, however, require the approval of the Panel where the refund is made over by the principal company of a group to an excess profits tax subsidiary—see Sixth Schedule, Part II, paragraph 4 of the Act.)

(3) The Panel will approve cases in which the refund is made over unconditionally or as a loan for use in the original trade or business or for use in a trade or business carried on or to be carried on by a relative of the taxpayer (relative being defined as in the last paragraph of Section 39 (2) of the Act) provided that in the loan cases the loan is fixed for a period of at least five years and the interest, if any is charged, is reasonable.

(4) Where the refund is made over for use in a trade or business in which the taxpayer or a relative of his has or is to have a substantial interest the Panel will approve cases where it is made over unconditionally or subject to the conditions mentioned in the previous paragraph as a loan and where the interest in the business is 20 per cent. apart from 'any interest acquired by or for him in consideration of the making over'. In other words the Panel will regard the expression 'substantial' in Section 39 (2) (c) of the Act as satisfied by a 20 per cent. interest.

(5) The Panel will not approve cases in which the refund is made over for a cash or equivalent consideration.

Use of refunds—development and re-equipment

(6) The fundamental principle behind the payment of refunds is that they shall be used to develop or re-equip a specified trade or business.

(7) The receipt of a refund will normally give rise to an increase in the net worth of the business concerned, that is the capital and reserves of the business as represented by the excess of the assets of the business over its liabilities. The Panel will expect this increase in net worth to be shown and maintained separately on the balance sheet of the business as a capital reserve. Where a refund is received as a loan there will be no such increase in net worth, but the Panel will expect the loan to be maintained and shown separately on the balance sheet.

Development

(8) In general 'development' will be clearly identifiable where the refund has been used to expand the capital employed in the business as represented by the fixed assets and working capital of the business. The reduction of a bank overdraft or the discharge of other liabilities will be regarded as such an expansion of capital.

(9) The Panel will be prepared to regard as development, expenditure out of the refund on special advertising, research and other similar expenditure aimed at improving the business provided that it is capitalised and treated as a capital asset against reserves. Expenditure of this nature charged to profit and loss will not be regarded by the Panel as development.

Re-equipment

(10) The Panel will regard as re-equipment of a trade or business any expenditure on assets where the effect is to obtain more for less efficient buildings, plant, machinery, equipment, &c.

(11) To the extent that relief from taxation falls short of the expenditure,

rehabilitation expenses as defined by the Finance Act, 1946 (broadly speaking, expenditure on the removal of A.R.P. installations, the return of evacuated businesses and the re-adaption of buildings, plant, machinery, &c., for peace-time production), may be charged against the refund. The Panel will not, however, regard as so chargeable expenditure on deferred repairs.

Improper use of refunds

(12) Section 40 (1) (b) of the Finance (No. 2) Act, 1945, lays it down that any part of the net refund which is not used for development or re-equipment of a business 'shall not be directly or indirectly distributed by way of dividend or cash bonus or capitalised for the purpose of issuing bonus shares or debentures or releasing any liability for uncalled share capital or applied, whether by way of remuneration, drawings, loans or otherwise, for the benefit of partners, shareholders, or proprietors'. As has already been stated, the receipt of a refund will normally give rise to an increase in the net worth of the business concerned. The normal test to be applied by the Panel in determining whether or not any part of a refund has been directly or indirectly distributed for the benefit of the partners, shareholders or proprietors will be the movement of the net worth of the business, due regard being paid to the normal level of the provision for depreciation and to the course of profits and their disposal.

(13) Any distribution of free or capital reserve will in the view of the Panel constitute a *prima facie* case for enquiry in order that the Panel may satisfy itself that the refund is not being indirectly applied in a manner contrary to the undertakings given under the Act. In any case in which the distribution of profits in respect of the year or period concerned for the benefit of partners, shareholders or proprietors exceeds the amount of the profits for that year or period, the Advisory Panel would feel obliged to satisfy itself that the undertakings given in respect of the refund were not being infringed.

(14) It will also be clear that the question of the distribution of existing reserves is linked with the disposal of the current earnings of any business which has received a refund. The Chancellor of the Exchequer has already made it clear that any increase in current earnings which results from the benefits conferred by the use of a refund may be freely dealt with in the same way as earnings generally. (Hansard, 22nd July, 1946, columns 294-295).

Miscellaneous

(15) Section 40 of the Act requires that, until the refund has been used for developing or re-equipping a business, it is to be 'so dealt with as to remain available for use, when required, in developing or re-equipping the trade or business'. As long as any part of a refund remains unused, the Panel will be assisted in carrying out its duties if any such unused part is separately distinguished among the assets of the business. The Panel will regard investment in Government or other marketable securities as complying with the requirement that a refund should remain available for use.

(16) The work of the Panel will be facilitated if reports of directors to their shareholders or the accounts indicate how a refund has been used.

(17) The Panel calls attention to the provisions of Section 47 of the Finance (No. 2) Act, 1945, which provides that, subject to specified conditions, the Commissioners of Inland Revenue may give credit for the net amount of any excess profits tax refund (after deduction of income-tax at the standard rate for the year 1946-47) against excess profits tax liabilities. Any such credits are to be deemed to have been paid to the Commissioners and repaid by them and the undertakings and authorities in respect of the refund are, with the necessary modifications, to have effect accordingly.

(18) Finally, the Advisory Panel draws attention to the provision of Section 50 (4) of the Act, under which any part of the refund used in or towards the recoupment of expenditure in developing or re-equipping a business which has been incurred on or after the first day of April, 1945, is to be regarded as expenditure on development or re-equipment for the purpose of satisfying the undertakings given in respect of the refund.

Treasury Chambers,
Great George Street, S.W.1.
8th November, 1946.

P. L. SMITH
(Secretary).

AMENDMENTS TO RECOMMENDATIONS III AND VI
(issued in May, 1948)

The following amendments to previous recommendations were issued in May, 1948, by the Council of the Institute. They arise from the statutory definition of 'provision' in paragraph 1 (1) (a), Part IV, First Schedule to the Companies Act, 1947.

RECOMMENDATION III

The treatment of taxation in accounts

In the opinion of counsel an amount set aside to meet future income-tax is not a liability and accordingly cannot be a 'provision'; it follows that for the purposes of the schedule it is necessarily a reserve. In view of that opinion, Recommendation III requires amendment in the following respects:

- (a) The word 'provision' ceases to be applicable to amounts set aside to meet future income-tax.
- (b) Such amounts should in all cases be grouped with reserves; the alternative of stating them separately as deferred liabilities ceases to be available.

RECOMMENDATION VI

Reserves and provisions

In the opinion of counsel nothing that does not fall within the definition of 'provision' can properly be described as a provision. In view of that opinion the amounts referred to in paragraph 1 (b) (i) of Recommendation VI (paragraph 44 of the booklet published by Gee & Co. (Publishers) Ltd.) cannot be described as provisions and the Council has made the following new recommendations:

- (a) The word 'provision' should cease to be used to denote amounts set aside to meet specific requirements the amounts whereof can be estimated closely; such amounts should be grouped with creditors since they represent liabilities or accruals.
- (b) Amounts set aside to meet deferred repairs the execution of which is a contractual or statutory obligation (e.g. under a dilapidations clause of a lease) should be treated as liabilities if the amounts can be determined with substantial accuracy and as provisions if the amounts cannot be so determined.
- (c) Other amounts set aside to meet deferred repairs because they are regarded as charges necessary for the correct computation of profits should be treated as provisions, on the footing that they are closely analogous to amounts provided for renewals (which are specifically required to be treated as provisions) and differ from these in degree rather than in character.

XII. RISING PRICE LEVELS IN RELATION TO ACCOUNTS

In periods when rises in price levels are marked, businesses tend to become under-capitalised and the problems thereby created have been increasingly emphasised in recent months in annual reports, chairmen's speeches, the financial Press and elsewhere. As stocks of materials are converted into goods and sold and as fixed assets wear out or become obsolete, substantially greater amounts have to be invested in the assets which replace them than were invested in the purchase of those displaced; other working capital requirements likewise increase.

In some businesses the immediate effects of a rise in price levels are more apparent than in others. Those where rapid stock replacement occurs feel the results quickly, and those whose plant and equipment call for immediate or early replacement feel the effect more rapidly than those for which replacement is a long-term problem. But in nearly all businesses the under-capitalisation will be felt sooner or later if the rise in prices is maintained.

The maintenance of the capacity of the business to cope with the physical volume of goods or services previously handled depends to a large extent upon the correction of this under-capitalisation. This can be done either by obtaining new capital from outside sources or by retaining in the business moneys which would otherwise be free for distribution; or by a combination of these methods.

The raising of new capital from outside sources necessarily implies a surrender

by the proprietors of a proportion of their equity in the business or the introduction of prior ranking capital. Some fear that the adoption of this method may later involve the drastic pruning of the capital structure, as happened in the case of some companies in the decade which preceded the last war; but the alternative of retaining resources in the business has its difficulties also.

The basis and scale of taxation in force in Great Britain are such that the extent to which profits can be retained in businesses for the purpose of adjusting the under-capitalisation is seriously restricted. The difference between the original monetary cost of stocks sold and the amount realised on the sale in the ordinary course of business is brought into account for taxation purposes; moreover, the allowances for taxation purposes in respect of the fixed assets are restricted to an amount equal to their original monetary cost. Profits are subjected not only to income-tax at 9s. in the £, but also to profits tax in the case of corporate bodies and sur-tax in the case of individuals and partnerships. The amounts which might otherwise accrue in the course of trading and become available for meeting increased costs of replacement are thus gravely diminished.

The combined effect of the rise in price levels and the oppressive burden of taxation has led a number of business men and their advisers to question the validity of the methods of profit ascertainment hitherto generally followed by industrial and commercial undertakings. They do not challenge the generally accepted accounting principle that the profit of a period can be ascertained only after providing, by way of charges against revenue, adequate sums for remedying any impairment of the capital of a business which may have occurred in the ordinary course of trading in that period. Opinions differ, however, as to whether capital for this purpose means (a) the money contributed by the proprietors, including profits left by them in the business for financing it, or (b) the power of that sum of money to purchase a particular volume of goods or equipment. Some business men have adopted the latter conception and accordingly maintain the proposition that profit can be stated correctly only if it is ascertained after treating as revenue charges sums sufficient to provide the increased funds necessary for replacing the stocks consumed or sold and for providing an appropriate proportion of the prospective enhanced cost of replacing the fixed assets used up in carrying on the business.

This proposition is at variance with the accounting practice hitherto generally followed of treating as charges to revenue the actual monetary cost of the stocks consumed or sold and depreciation provisions representing the appropriate proportion of the amounts carried in the books for fixed assets (usually their historical cost). Those who maintain the view hitherto accepted, point out that logical application of the method advocated by those who desire a change would require them in ascertaining profit not only to make charges against revenue on new bases in respect of stocks and fixed assets, but also to provide for the diminished purchasing power of cash and other liquid assets to be used in the business. They put forward the criticism that it would be illogical, in ascertaining profit, to treat as a necessary charge the cost of maintaining the purchasing power of money provided by the issue of fixed preference or loan capital, whilst ignoring the corresponding diminution in the obligation, expressed in terms of purchasing power, to the holders of that capital. They emphasise that if the new conception were adopted the holders of preference shares might be deprived of dividends without acquiring any capital benefit. Moreover, they point out, as regards goods consumed or sold, that those who desire the change have not yet been able to devise a satisfactory method, suitable for general use, of applying the principle advocated and, as regards fixed assets, that, owing to improved processes of manufacture, plant which becomes worn out or obsolete is not invariably replaced. Further, they claim that not only is the suggested change wrong in principle, but also that it strikes at the root of sound and objective accounting because of the practical difficulties of assessing the amounts which would be treated as charges to revenue if the new conception were adopted.

Some suggest that apart from the taxation consequences, which are inescapable in the present state of the law, the problem should be met by arranging, so far as fixed assets are concerned, that the amounts (generally their depreciated historical cost) at which they are carried in the books should be written-up to the

amounts which it is estimated might have to be paid if they were to be replaced at the present time by identical assets in a comparable state of depreciation. They also suggest that depreciation should thereafter be calculated upon the written-up figures, but there is not unanimity among them as to whether the future annual instalments of depreciation should be calculated so as (a) to amortise over the residue of the effective life of each asset the whole of the gross replacement cost (i.e. the amount which would have to be paid at the present time to acquire similar assets in a new condition) less the provisions for depreciation already made, or (b) only to provide annually one year's proportion of the gross replacement cost based upon the total life of the asset, ignoring the fact that provisions for earlier years were calculated upon smaller capital sums. In the absence of a sufficient fall in prices, the adoption of the latter method would fail to secure the provision of the funds required by the eventual replacement date, but, on the other hand, might be regarded as providing a fair charge against the revenue of each year on the new basis; it would need to be supplemented out of profits or otherwise in order to provide the necessary funds.

Apart from the question of depreciation, the writing-up of the fixed assets itself involves practical difficulties, including, *inter alia*, those which arise because relative stability of prices on a new level has not yet been attained, the invalidation of comparisons with figures of previous periods and, in many cases, the lack of data on which satisfactory revaluations could be achieved.

In certain European countries assets have been written-up by the use of price indices, with governmental encouragement in the shape of additional taxation allowances; in Great Britain no such benefit is available and the extra sums provided for depreciation, as in the case of other sums provided to meet increased replacement costs, would be treated as disallowable charges for taxation purposes.

The foregoing matters have been the subject of much discussion among business men and their advisers in Great Britain and North America. There is no generally accepted conclusion in either territory as to the way in which the problems should be solved. It is, however, clear that in Great Britain the effects of the rise in prices when combined with the effects of the basis and scale of taxation cannot, unless profits are sufficient, be met by changes in accounting practice; Parliament alone has the power to mitigate these consequences by changes in the tax law.

The majority of businesses maintain their past practices for the ascertainment of profits and set aside out of those profits such additional sums as are found practicable towards meeting the enhanced costs of replacement. The setting aside of profits for this purpose is viewed by their directors as a major requirement when deciding upon the amounts which they can prudently recommend for distribution in dividends. Some boards of directors are so impressed with the importance of emphasising to their shareholders the implications of the matter that they set aside the sums concerned on the basis of a programme designed to provide by instalments, over the period during which the assets are in effective use, the funds which it is expected will be needed for their replacement. The financial effects of such a plan are identical with those of schemes involving a drastic change in the basis of profit ascertainment as outlined in earlier paragraphs, the material difference being that the extra amounts set aside are treated as appropriations of profits instead of as charges made before profits are ascertained.

Owing to the inherent difficulty of determining in advance the prices which may have to be paid in the future for the replacement of assets, it is impracticable to forecast with any precision the additional reserves which will be required. This fact alone is likely to necessitate modification of any plan whereby the actual sums required to effect replacements are provided by instalments over a period of years, either by way of supplementing depreciation charges or by setting up in lieu of depreciation a provision for renewals based on estimated replacement costs. Moreover, the gap between historical and replacement costs might be too big to be bridged in these ways.

The matters mentioned in the foregoing paragraphs have been under close examination by the Council and the advice given in the Council's recommendations IX and X, issued in 1945, has been re-examined. In Recommendation X

the Council emphasised that profit or loss on trading is the difference between the amount for which goods are sold and their historical cost including expenses of sale and delivery; it recommended that for accounting purposes the basis of valuation for stock-in-trade should normally be the historical cost (or, if lower, the market value as defined in the recommendation). In Recommendation IX the Council expressed a similar view with respect to fixed assets when it emphasised that depreciation provisions should be based on cost and stated in paragraph 5 that: 'Amounts set aside out of profits for . . . a possible increase in the cost of replacement are matters of financial prudence (and cannot) be estimated with any degree of accuracy. They are in the nature of reserves and should be treated as such in the accounts.' The advice thus given on replacement costs was subsequently endorsed from the legal standpoint by counsel whose opinion was taken by the Institute upon the implications of the Companies Act (see paragraph 92 of the Institute booklet—published in May, 1948—on the Companies Act, 1947).

The Council sees no need to modify the advice which it has already given, but amplifies this advice in the recommendations set out below. It wishes, however, to draw attention to the fact that the funds which can be accumulated by businesses through charging sums against revenue in absorption of the historical cost of goods sold and assets consumed must, if the enhanced levels of prices are maintained, be inadequate to meet the cost of replacing goods and assets which were purchased at substantially lower levels. It is necessary also to recognise that rising prices, coupled with the present basis and scale of taxation, seriously impair the ability of industry and commerce to maintain their volume of trade or services at pre-war levels and make necessary the taking of steps to strengthen their financial resources for this purpose.

It is, therefore, of the greatest importance that directors should be advised to consider, in relation to the circumstances of their company, the effects of the rise in price levels and the relative merits of (a) relying upon the company's ability to raise new capital as and when it may be required for the purpose of meeting enhancements in replacement costs, and (b) the desirability of setting aside and accumulating out of profits such sums for this purpose as may be practicable. In many cases this consideration may be a matter of major importance in determining the amount of profits which, from the standpoint of financial prudence, should be regarded as available for dividend. It should be borne in mind that if carried to extremes the retention of profits might involve the severe curtailment or even cessation of dividends and the imposition of undue burdens upon existing shareholders, including preference shareholders, for the benefit of future holders of the equity shares.

The desirability of informing shareholders, as to the effects of the rise in price levels on their own company's affairs and as to the steps taken or contemplated to meet them, is a matter for consideration by directors. Where an amount set aside out of profits is determined in accordance with a programme designed to provide the necessary funds by instalments over the period during which the assets are in effective use, the information given should indicate the facts.

RECOMMENDATIONS

The following further recommendations are now made in amplification of Recommendations IX and X.

(1) Any amount set aside to finance replacements (whether of fixed or current assets) at enhanced costs should not be treated as a provision which must be made before profit for the year can be ascertained, but as a transfer to reserve. If such a transfer to reserve is shown in the profit and loss account as a deduction in arriving at the balance for the year, that balance should be described appropriately.

(2) In order to emphasise that as a matter of prudence the amount set aside is, for the time being, regarded by the directors as not available for distribution, it should normally be treated as a specific capital reserve for increased cost of replacement of assets.

(3) For balance sheet purposes fixed assets should not, in general, be written-up on the basis of estimated replacement costs, especially in the absence of a measure of stability in the price level.

(14th January, 1949.)

XIII. ACCOUNTANTS' REPORTS FOR PROSPECTUSES: FIXED ASSETS AND DEPRECIATION

The report by a company's auditors, which is required for prospectus purposes under the Fourth Schedule to the Companies Act, 1948, must deal with:

- (a) the profits or losses in respect of each of the five financial years immediately preceding the issue of the prospectus; and
- (b) the assets and liabilities at the last date to which the accounts were made up.

Similar reports by accountants are required in respect of any business which is to be acquired out of the proceeds of an issue. In practice the reports generally deal with profits or losses over a period of ten years in order to comply with Stock Exchange regulations.

Such reports must either indicate by way of note any adjustments as respects the figures of profits or losses or assets and liabilities dealt with by the report which appear necessary to the persons making the report, or must make those adjustments and indicate that adjustments have been made. Among the matters which may require adjustment are the treatment of fixed assets and the depreciation thereof.

The amounts at which fixed assets stand in the books normally depend on the price levels at the time of acquisition and the depreciation policy adopted since that time; they are not usually intended to indicate the current values of the assets. Frequently, however, a company obtains from an expert a valuation of fixed assets for inclusion in a prospectus. Under existing conditions such a valuation may be greatly in excess of the amounts at which the assets stand in the books. In some cases the valuation figures may be adopted for the purposes of the company's books, but in others they may be used for prospectus purposes only without being incorporated in the books.

Where the valuation is incorporated in the books, depreciation will in future necessarily be calculated on the valuation figures, resulting in future earnings being charged with sums which might be considerably in excess of those charged in the accounts during the period covered by the report. Consequently, a report dealing with assets and liabilities on the basis of the valuation taken into the books would mislead intending investors, if the figures stated in the report for past profits or losses were arrived at after providing for depreciation on amounts considerably less than the valuation without any indication being given in the report of the effect of the valuation on future depreciation provisions. Similar considerations arise in the case of a business acquired, or to be acquired, on the basis of a valuation of fixed assets greatly in excess of the amounts carried for such assets in the books of that business at the time of acquisition.

Where, on the other hand, the valuation is used by the directors in the prospectus for the purpose of indicating the assets cover for the issue, but the valuation is not incorporated in the books, then depreciation provisions will be calculated in future on the book amounts, which may be substantially less than the valuation. In this case, subsequent profits will be ascertained correctly by reference to depreciation charges based upon the book amounts, but the assets cover indicated by the directors will not normally be maintained unless, out of profits earned during the effective life of the assets which are subject to depreciation, reserves are set aside at least equal to the excess of the valuation of those assets over their book amounts. The same need for reserves arises in the case of a holding company where a valuation of the fixed assets of subsidiaries is used by the directors in the prospectus, but is not incorporated in the books of the subsidiaries. In these cases the creation of the whole or part of the necessary reserves may be obligatory under the terms of the prospectus if the issue is one of redeemable preference shares or debentures; but, whatever may be the terms of the issue, intending investors may be misled in regard to the assets covering their subscriptions unless the necessity for retaining profits, up to the amount of the excess, is recognised fully by the directors in their representations in the prospectus as to the profits which they anticipate will be available for future dividends. The context in which the accountants' report appears may thus have a material effect on the conclusions which the intending investor will draw from the prospectus as a whole.

Special considerations arise where the cost to a holding company of shares

in its subsidiaries is in excess of the amounts at which the underlying net assets are carried in the books of the subsidiaries. In some cases the profits of the group may not be stated fairly unless they are arrived at after charging depreciation on that part, if any, of the excess which relates to fixed assets. Circumstances of companies differ greatly and each case has to be considered on the facts. Among the matters requiring consideration is the extent to which the excess is attributable to such assets as goodwill or freehold land, which are not generally regarded as subject to depreciation, or to depreciating assets such as leaseholds, buildings, plant and machinery; the allocation of the excess between the several types of asset will affect the depreciation, if any, which should be provided and, consequently, the profits.

Another important aspect is that of taxation. If the allowances for taxation purposes are materially different from the corresponding provisions made for depreciation, the net profits after deducting depreciation provisions may give a misleading indication of the profits for taxation purposes and consequently of the net amount available for distribution. A similar position may arise where a material part of the assets comprises depreciating assets on which no allowance is obtainable for taxation purposes. Further, where in future the depreciation provisions will be calculated on a valuation which is not applicable for taxation purposes, the written-down amount for taxation purposes (representing the total maximum amount available for future taxation allowances) may be substantially less than the valuation; where this is so, provisions for depreciation in future will be greater than the allowances for taxation purposes. In circumstances such as the foregoing, the excess of the depreciation provisions is not the whole amount involved; to set aside the full depreciation provisions required, the company will have to earn not merely the excess over the taxation allowances but such an amount of taxable profit as after deduction of income-tax and profits tax will leave a net sum equal to the excess.

The foregoing paragraphs and the recommendations that follow relate to circumstances in which it may frequently be necessary to make adjustments in respect of fixed assets and depreciation, but it must be borne in mind that the circumstances of one company may differ greatly from those of another. It is necessary to take into account the relevant facts of each case before deciding what, if any, adjustments should be made and what matters should be referred to specifically in the accountants' report.

RECOMMENDATIONS

It is therefore recommended that the following principles should normally be applied by members of the Institute who may be called upon to report for prospectus purposes:

(1) If material to the presentation of the figures, the amounts charged for depreciation in the years under review should be stated in the report.

(2) Where there has been a change (whether of rates or by reason of a valuation) in the basis of depreciation during the period covered by the report, the effect of the change should be indicated in the report if the effect is material and cannot be dealt with appropriately in the adjustments made in arriving at the figures shown in the report.

(3) Where the allowances obtained for taxation purposes differ materially from the corresponding charges made for depreciation in arriving at the profits or losses shown in the report:

(a) If the difference is material in relation to the profits or losses shown, the report should indicate the fact and should state the amount of the difference (or give the relevant amounts) for the last year covered by the report or for such other period as may be appropriate;

(b) If the allowances obtained are substantially greater than the amounts charged, it is a matter for consideration whether adjustments should be made so as to substitute the amounts of the allowances for the depreciation charged.

(4) Where the amounts chargeable in future for depreciation are materially in excess of the allowances obtainable for taxation purposes (for example, because the assets include assets on which no allowance for taxation is obtainable, or

because of a winding-up of assets on a revaluation, or because of the acquisition of a business on terms that the purchase price of depreciating assets is materially in excess of the amount on which allowances for taxation purposes are available to the purchaser):

- (a) The report should indicate the extent of the excess of the depreciation chargeable over the taxation allowances obtainable for the year immediately subsequent to the period covered by the report;
 - (b) The report should also indicate that owing to the disallowance for taxation purposes of this excess, the sum required to cover it is the gross amount which after deduction of income-tax and profits tax will leave a net amount equal to the excess.
- (5) Where a valuation of fixed assets is adopted for the purposes of the books and accounts:
- (a) It is not normally appropriate or practicable, in a report dealing with a period during which there have been material changes in price levels, to make consequential adjustments in the depreciation provisions for past years;
 - (b) The report should, however, indicate the approximate future annual provision computed on the basis of the valuation and should give a comparison thereof with the actual provision made in arriving at the profit or loss shown in the report for the last year covered thereby.
- (6) Where a valuation of fixed assets is used by the directors in the prospectus in order to indicate the assets cover for the issue, but the valuation is not adopted for the purposes of the books and accounts:
- (a) The report should not include figures based on, or a reference to, a valuation in excess of the amounts standing in the books;
 - (b) Before consenting (under Section 40, Companies Act, 1948) to the inclusion of their report in the prospectus, the accountants should either:
 - (i) ascertain from the directors that the directors' estimates of future profits available for dividend, as shown in the prospectus, have been arrived at after appropriate deductions have been made for the profits which it will be necessary to retain as reserves (including profits set aside for the redemption of preference shares or debentures) in order to maintain the assets cover indicated in the prospectus; or
 - (ii) if such deductions have not been made, satisfy themselves that the disclosure is sufficient to show how far the directors have taken this factor into account.
- (7) In the case of a holding company effect should be given to the foregoing recommendations where either:
- (a) The cost of its shares in subsidiaries is materially in excess of the amount at which the underlying net assets are carried in their books and a material part of the excess relates to fixed assets which are subject to depreciation; or
 - (b) There is used in the prospectus a valuation of the fixed assets of the subsidiaries which is materially in excess of the amount at which such assets are carried in their books or (in a case where the valuation has been adopted by the subsidiaries for the purposes of their books and accounts) were so carried immediately prior to their adoption of the valuation.
- (8) In the foregoing recommendations references to 'allowances for taxation purposes' should normally be interpreted as the annual allowances (other than initial allowances, balancing allowances and similar items) obtained for income-tax purposes for the fiscal years of which the financial years are the basis years. In some cases, however, it may be more appropriate to apply the allowances for profits tax purposes. The circumstances of companies differ greatly and each case should be examined on its merits. In order to obtain a fair basis of comparison it may, for example, be necessary in some cases to take into account, whether by way of spreading or otherwise, initial and balancing allowances and charges, particularly in respect of assets which have a short effective life or where the aggregate depreciation charges over a long period are being compared with the corresponding aggregate taxation allowances.

(11th March, 1949.)

XIV. THE FORM AND CONTENTS OF ACCOUNTS OF ESTATES OF DECEASED PERSONS AND SIMILAR TRUSTS

The purposes for which trust accounts are prepared are in essence the same as those for which other accounts are prepared. These purposes are to record the transactions of persons entrusted with administration or management and to convey to interested parties information relating to those transactions and the position achieved thereby. In the case of executorship and similar trust accounts the interested parties will normally be the trustees, the persons entitled to life-interests and the ultimate beneficiaries. Information from the accounts may also be required for taxation and other purposes.

In addition to being accountable for money and other assets coming into their hands, trustees are responsible for the administration of the trust estate. The extent of their responsibility will therefore not be apparent unless the periodical accounts show both aspects. To show both aspects involves the recording of all the assets and liabilities of the estate, so that a balance sheet will show the position of the estate as a whole and not merely the position regarding those assets which have come into the hands of the trustees. In many cases it also involves the distinguishing of realised estate from unrealised estate.

There is a fundamental distinction in executorship and similar trust accounts between transactions on 'income' account and those on 'capital' account. Unless this distinction is made clear in the periodical accounts they will not reveal the respective positions of life-tenants and remaindermen, whose interests may be conflicting. To make the distinction clear, it is necessary to prepare separate capital accounts and income accounts and to distinguish in the balance sheet between capital and income items.

Beneficiaries are frequently persons with little knowledge of accounting but with considerable interest in the trust estate or its income. The importance of simplicity and clarity in trust accounts cannot therefore be over-emphasised. The position shown by the balance sheet, the income account and the estate capital account will not readily be apparent if they are overloaded or obscured by detailed information. Details can conveniently be shown in schedules and subsidiary accounts, cross-referenced to the main accounts. In this way it is possible for trustees and beneficiaries to appreciate the general position of the estate as disclosed by the main accounts, whilst at the same time the totals included in those accounts are supported by full details for those who may be interested in particular items. The trustees may consider it desirable, in the interests of all parties, that they should sign the periodical accounts and that beneficiaries should formally signify agreement with their personal accounts. The adoption of this course is greatly facilitated by simplicity in the presentation of the accounts.

Legal considerations, including questions such as equitable apportionment between capital and income, affect the accounts of trustees. It is therefore necessary for the trustees to have regard to all relevant statute and case law and also to the terms of the will or other trust instrument, which may expressly exclude the operation of legal rules which would otherwise apply. This recommendation does not purport to deal with the legal aspects of such matters; these may need consideration by the trustees' legal advisers.

It may become necessary for trustees to satisfy the requirements of a court of law. In such cases the requirements of the Court will depend upon the nature of the proceedings. Normally, the first concern of the Court is in relation to the accountability of the trustees and the Court may therefore require the trustees' transactions to be examined in conjunction with the appropriate vouchers. This recommendation does not deal with the form in which accounts may be required by the Court; but if the books and records are kept on the principles recommended below they should provide the information to enable the trustees to satisfy the Court's requirements where it becomes necessary to do so at any time.

Accountants are frequently called upon to prepare accounts for trustees. In such cases the accountants may deem it necessary to submit with the accounts, which are the responsibility of the trustees, a report explaining the principles adopted in their presentation and drawing attention to particular factors, problems or outstanding matters. This recommendation does not deal with the form of such reports, although it may facilitate their preparation. Nor does

the recommendation deal with the form of report required where accountants are called upon to audit accounts prepared by or for trustees.

The recommendations below relate to the accounts of the estates of deceased persons and similar trusts. It will be understood that references to legacy and succession duties are not relevant in the case of estates affected by the abolition of these duties by the Finance Act, 1949. In view of the considerable diversity of purposes for which and circumstances in which trusts are created, the recommendations may not apply fully throughout the entire field of trust accounts; but it is considered that in all trusts the fundamental principles do not differ in substance from those now recommended. It may be desirable to emphasise that trusts are so varied in their nature that there must be flexibility in the manner of presenting accounts. A standard form to suit every trust is neither practicable nor desirable.

RECOMMENDATIONS

It is therefore recommended that the following principles should normally be applied by members of the Institute in connection with the books and the preparation of accounts of estates of deceased persons and, with modification of detail or expression, the accounts of similar trusts.

General principles

(1) The books should contain all the information from which, in the light of the trust documents and legal considerations, periodical statements of account can be prepared. They should give all the material that may be required at future dates (possibly long deferred) for any review of the transactions of the trustees. The only satisfactory way of achieving this is to keep the books on ordinary double-entry principles, the entries being detailed fully and supplemented where appropriate by subsidiary records such as an investment register.

(2) The periodical accounts prepared from such books should show not only the position at the accounting date, but also full information explaining the administration of both capital and income during the period from the commencement of the trust or since the last account. In addition to recording all transactions for the period under review, it may be desirable in certain cases to summarise the capital transactions from the inception of the trust to the date of the accounts.

(3) Income and capital transactions should be segregated clearly. This may often be facilitated by the use of separate columns in cash books and ledgers.

(4) Periodical accounts should normally consist of:

(a) balance sheets of the whole of the trust estate, including separate trusts arising out of the will or other trust instrument;

(b) estate capital account, summarising the transactions on capital account since the date of death of the last account, with separate accounts on a similar basis for any special funds;

(c) income account, with separate accounts for any special funds;

(d) schedules and subsidiary accounts explaining in greater detail the major items appearing in the balance sheet, capital accounts and income accounts.

(5) The balance sheet, the estate capital account and the income account should be presented in the simplest manner possible, all detail being relegated to the schedules and subsidiary accounts.

Note.—It may be useful to include with the accounts an epitome of relevant provisions of the will or other trust instrument.

(6) The date to which accounts are made up should be decided according to the circumstances and will not necessarily be the anniversary of the creation of the trust. As a general rule, having regard to the taxation liabilities of the trust and of the beneficiaries, it may be convenient for accounts to correspond with fiscal years; but in some cases it may be necessary for accounts to be made up to the anniversary of the date of death if the rules of law relating to equitable apportionments are applicable or if there are other special circumstances. The nature of the assets of the trust, the dates on which income is receivable, the due dates of annuities, are all factors that may affect the selection of the most convenient accounting date.

BALANCE SHEET

Grouping

(7) The various items in the balance sheet should be grouped under appropriate headings, so that significant totals are readily apparent.

Distinction between capital and income

(8) Items relating to capital should be distinguished from those relating to income, either by appropriate grouping to show the aggregate of each or by the use of separate capital and income columns.

Comparative figures

(9) Comparative figures should be included if they serve a useful purpose. Normally, however, the supporting schedules (in particular the investment schedules and the capital cash summary account recommended later) will be more informative than a comparison of total figures with those on the previous accounting date.

Estate capital account

(10) The capital account in the balance sheet should show the balance of the estate capital, so far as it has been ascertained, after deducting distributions which have been made. In some cases it may be sufficient to show the net figure but in others it will be desirable to show both the gross figure and the distributions to date.

(11) Where the value of a material part of the estate has not been agreed for estate duty purposes the position should be explained by note.

Liabilities

(12) Liabilities on capital account should include unpaid legacies, outstanding death duties that have been ascertained, unpaid debts owing by the deceased and, so far as they relate to capital, administration expenses accrued due.

(13) Balances due to life-tenants should be distinguished from other liabilities on income account.

(14) All accruing liabilities on income account will normally have been brought into account (see paragraph (50)). Any material amounts not so brought in (for example, interest accruing on unascertained death duties) should be recorded by note.

(15) A note should be made in respect of any known liabilities of which the amounts cannot be determined with substantial accuracy; for example, death duties in dispute or not yet calculable.

(16) Contingent liabilities, such as contingent legacies and liabilities that may arise under guarantees given by the deceased, should also be recorded by note.

Assets

(17) Realised and unrealised estate should normally be distinguished. This is particularly important if questions of equitable apportionment arise under the rules laid down by the Court from time to time in decided cases. The distinction between realised and unrealised estate may cease to be necessary after all questions of equitable apportionment have been dealt with, even where investments of the testator are retained by the trustees or appropriated to settled or other special funds. The distinction should, however, be maintained so long as any of the unrealised investments are of a kind which the trustees, though authorised to retain, would not have been authorised to purchase.

(18) Subject to (19) below, assets should be stated at the valuations adopted for estate duty purposes, or at cost to the estate. They should not be adjusted to values shown in the residuary account for legacy duty purposes, or to market values calculated for the purpose mentioned in (21) below. Where, however, special circumstances arise, such as a partial division of the estate in specie, the assets as a whole may be revalued and the accounts may then continue to those valuation figures.

(19) The valuations adopted for estate duty purposes will subsequently be reduced in the accounts where a proportion of income received after the date of death is treated as a realisation of capital (see paragraph (48)). Where statutory apportionments are excluded by the trust instrument, so that the whole of the income received is credited to income account, it may nevertheless be necessary to adjust both the asset account and the estate account, especially if the proportion of income relating to the period up to the date of death is material; such an adjustment would always be required where, for estate duty purposes, accrued interest receivable had been added to the amount of a mortgage, or the full amount of dividend had been added to shares quoted ex-dividend.

(20) The nominal amounts of investments should not be used as values for accounting purposes. They should, however, be noted in the supporting schedules. (See paragraph 63 (a)).

(21) Quoted and unquoted investments should be segregated and the aggregate market value of the quoted investments stated by note. The details in relation to each investment should appear in the schedules supporting the balance sheet totals.

(22) It may be desirable to make a further classification of investments showing a separate group total for each class; for example, properties, trustee stocks, other stocks, mortgages.

(23) The composition of cash and bank balances as between capital, income and special funds should be shown. If the grouping adopted for the balance sheet as between capital, income and special funds makes it necessary, one bank balance will have to be divided so that the appropriate amounts appear under their proper headings in the balance sheet.

(24) A note should be made in respect of any known assets of which the amounts cannot be determined with substantial accuracy; for example, reversions and claims for damages.

Special funds

(25) Where special funds arise by reason of the existence of separate trusts or settled funds within the main administration, the capital and liabilities of such special funds should be stated under separate headings and the corresponding assets should also be stated separately.

ESTATE CAPITAL ACCOUNT

(26) The estate capital account should explain in appropriate detail the capital account balance shown in the balance sheet.

Assets and liabilities at date of death

(27) For the first accounting period the capital account should show the assets and liabilities at the figures included for estate duty purposes, a balance being struck to show the net estate as declared for duty and subdivided, if necessary, to show:

- (a) property liable to duty;
- (b) property not liable until falling into possession;
- (c) property exempt from duty.

(28) Changes arising from corrective affidavits in subsequent accounting periods should be brought into account in those periods.

Estate duty

(29) Where appropriate the capital account should show the total on which estate duty is payable, the rate of duty and the amount paid; also, the information relating to estate duty should include matters such as the lower rate of duty applicable to agricultural property, marginal relief and a reference to any property which is aggregable for duty purposes though not forming part of the estate for which the trustees are accountable.

(30) In some cases the agreement of valuations for estate duty purposes may be a protracted matter extending over several years; for example, where the estate includes unquoted shares, shares in controlled companies, business goodwill or unusual complications. Where such a position arises the fact of the estate duty being provisional should be stated with an indication, where appropriate and practicable, whether the outstanding amount involved may be material.

(31) Any other material matters affecting the estate duty should also be stated in the capital account.

Trustees' transactions

(32) The capital account should record, suitably classified and in adequate detail, the transactions of the trustees showing the extent to which the estate has been increased (for example, by surpluses on realisations) and decreased by the payment of estate and succession duties, administration expenses, legacies and by appropriations to special funds, deficiencies on realisations, or otherwise.

Apportionments

(33) The provisions of the trust instrument as affecting statutory and equitable apportionments should be observed.

(34) Normally the capital account is not affected by the receipt of income of which a proportion relates to the period up to the date of death (see paragraph (48)). Where, however, statutory apportionments are excluded by the trust instrument it may be necessary to make an adjustment to both the capital account and the relevant asset account (see paragraph (19)).

(35) Where it has been necessary to make an equitable apportionment any amount credited to capital should be stated separately.

(36) Where there have been payments of succession duty or legacy duty, an indication should be given of whether the whole has been charged to capital or whether some part has been apportioned to income.

Outstanding liabilities

(37) All outstanding liabilities of material amount affecting the capital account should normally be provided for. (Liabilities not provided for should be noted on the balance sheet, as stated in paragraphs (15) and (16)).

Comparative figures

(38) Comparative figures for the preceding period will not normally serve a useful purpose in the capital account.

Cumulative totals

(39) Cumulative totals from the commencement of the trust should be included where it is of advantage to do so.

Special funds

(40) Special funds, dealt with separately in the balance sheet, should have their separate capital accounts.

INCOME ACCOUNT

(41) The income account should be presented in such a form as to give a clear disclosure of the transactions of the period and the amount available for division.

(42) All items involving considerable detail, such as investment income, should be included in total only, with appropriate reference to supporting schedule.

(43) The selection of a suitable accounting date (see paragraph (6)) should be regarded as an important factor in the presentation of the income account; for example, where the question of annuities and the income from which they are paid arises.

Income

(44) The income account should normally include all income received within the period of the account.

(45) The trustees are not normally required to account for income until it has been received, so that the account should not include income which though due at the accounting date has not been received. Where however a material item of income, due and normally received within the accounting period, has not been received, it may be desirable, in order to avoid distortion, to include the amount due with a corresponding debtor item in the balance sheet, provided it has since been received; if this is not done the account should indicate by note the item which has not been so included.

(46) Items such as rents collected but still in the hands of agents should be regarded for accounting purposes as having been received by them on behalf of the trustees and therefore brought into the income account with a corresponding item of debtors in the balance sheet.

(47) Items should be grouped in appropriate classification; for example, interest on government securities, dividends, interest on mortgages, rents, business profits, credits from realised capital on equitable apportionments.

(48) Where income is received which relates to a period partly before and partly after the date of death, the income account should be credited only with the proportion which has accrued since that date, unless there are contrary instructions in the trust instrument. The balance should be treated as a realisation of capital and credited to the relevant asset account. This principle applies whether an apportionment was included specifically in the valuation for estate duty purposes or was deemed to be included in the valuation of investments at the date of death.

(49) Dividends, interest and other income received under deduction of tax should normally be stated at the gross amount. (See paragraph (52)).

Expenditure

(50) The income account should include all amounts payable in respect of the accounting period, including amounts accrued up to the accounting date but not then due for payment. This accrual basis should normally be applied to all items, including annuities, chargeable to the income account.

(51) Items of expenditure should be grouped in appropriate classification; for example, annuities, interest on estate and succession duties, interest on bank overdraft, transfers to capital as a result of equitable apportionments, income-tax, administration expenses, succession duty (if any) apportioned to income and any legacy duties chargeable to income (indicating whether any part of the legacy duty on the residuary account, representing duty on income falling into the residuary estate, has been charged to income).

Income-tax

(52) The charge for income-tax should normally represent the full charge falling on the estate income, namely, tax under direct assessments *plus* tax deducted at source *less* tax recovered under repayment claims by the trustees and tax deducted from payments. This necessitates the inclusion of interest, annuities and similar items at the gross amount (whether or not tax was deducted by the trustees) and the inclusion of income at the gross amount (whether or not received less tax). Such treatment, besides showing the true incidence of income-tax on the trust income, facilitates comparisons with income and expenditure of other periods.

(53) If the income-tax details are considerable it is desirable to show them in a separate schedule.

(54) Where the income-tax charge arrived at in accordance with (52) above does not represent income-tax at the standard rate on the estate income, the position should be explained by note or narration and if necessary in the schedule. This position may arise, for example, where trustees pay income-tax under direct assessments after deduction of life-tenants' personal allowances, or where foreign income or other complications arise.

(55) In some cases it may not be practicable to follow the normal procedure referred to in (52) above; for example, where there are special difficulties arising from annuities free of income-tax and sur-tax. In such cases the income account should indicate clearly the treatment adopted.

Balance of income

(56) The income account should show the balance available after meeting expenditure chargeable against income and the manner in which the balance has been applied by the trustees; for example, amounts divided amongst the beneficiaries and transfers to accumulations accounts, indicating the bases of division in cases such as those where adjustment is required for interest on advances of capital to beneficiaries.

Comparative figures

(57) Comparative figures of income and of expenditure for the preceding accounting period should be stated if appropriate.

SCHEDULES AND SUBSIDIARY ACCOUNTS

(58) Whenever possible, detail should be relegated to schedules and subsidiary accounts, leaving only the significant totals in the main accounts.

(59) Appropriate cross-references should be given both in the main and the subsidiary documents.

Investments

(60) Unless investments are so few that they can be detailed conveniently in the main accounts, a separate schedule should be prepared.

(61) The schedule should be so drawn as to enable totals in the main accounts to be identified readily. The grouping of the items in the schedule should therefore correspond with the grouping adopted in the balance sheet and it may be necessary to have more than one schedule.

(62) Special funds dealt with separately in the balance sheet or income account should in any case have their separate schedules.

(63) The following information should be given in the investment schedule(s),

either in detail or by appropriate summaries, by the use of separate columns or otherwise:

- (a) Description and nominal amounts of investments, with estate duty value in the case of the testator's investments (see paragraph (18)) and cost or other book amounts of the trustees' investments; also, in the case of all quoted investments, the market value on the accounting date.
- (b) In the case of mortgages, details of the amount, security, rate of interest and due date thereof, with particulars of any arrears of interest.
- (c) The gross amount, the income-tax deducted and the net amount of interest and dividends.
- (d) The periods in respect of which income has been received and the rates of dividend, with any appropriate comments.
- (e) Purchases and sales of investments during the period and any surpluses or deficits arising on realisation.
- (f) Statutory apportionments of dividends between capital and income, shown item by item. (Equitable apportionments do not usually fall to be dealt with item by item. Any entries in the capital and income accounts for these apportionments should be explained by narration or by reference to a separate schedule if appropriate.)
- (g) In the case of real estate and leasehold estate, the estate duty value or cost or other book amount where available, with such details as tenure held, property expenses suitably analysed, rents received and particulars of any arrears.

Accounts with beneficiaries

(64) Accounts with beneficiaries should normally be presented. This is particularly important where the details are involved; for example, where there are periodical payments on account of income, accumulations accounts, maintenance accounts, or other special complications.

Capital cash summary account

(65) A capital cash summary account, containing in summarised form all significant information regarding the receipts and payments on capital account during the period covered by the accounts, should be presented where it is desirable to do so. The information shown by such a summary account will not normally be apparent in the estate capital account, which includes transactions other than receipts and payments. The summary account therefore provides a link between the capital cash shown in the balance sheet and that shown in the previous balance sheet.

Other schedules

(66) Examples of other matters for which separate schedules should be prepared, where the detail involved makes it desirable, are the following:

- (a) Debts due by the deceased, giving suitable particulars where the amounts paid differ from probate figures.
- (b) Debts due to the deceased, giving suitable particulars where the amounts received differ from probate figures.
- (c) Executorship or administration expenses on both income and capital accounts.
- (d) Pecuniary and specific legacies, showing the rates and amounts of legacy duty, the legacies paid or satisfied and whether the estate or the legatees were liable for the duty.

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